Structuring Executive Compensation
for LSA Leaders

Lutheran Services in America

STRENGTH & SERVICE SERIES

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PORTICO® Benefit Services | A Ministry of the ELCA

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- National CPA and consulting firm
- **Exclusively serving mission-focused nonprofits** for over 50 years
- Audit, review, tax, consulting, and cybersecurity services
- Depth of resources and expertise of a national firm; personal touch and caring relationship of a local firm

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Nonprofit Clients Nationwide, Including:
90+
Elementary & Secondary Schools
70+
Foundations
60+
Denomination Entities
80+
Employee Benefit Plans

Agenda

- Understanding Your Objectives
- Executive Compensation Best Practices
- Deferred Compensation Opportunities
    - Related IRS Regulations
    - Qualified Deferred Compensation Arrangements
    - Non-Qualified Deferred Compensation Arrangements

Understanding Your Objectives

- What are you hoping to accomplish with your compensation practices?
- What is your compensation philosophy?
- Who will be eligible for various compensation components?

Understanding Your Objectives (continued)

- What are you hoping to accomplish with your compensation practices?
  - Employee retention
  - Competitive compensation
  - Reasonable compensation
  - Makeup for prior under-compensation
  - Ensure adequate retirement funding

Understanding Your Objectives (continued)

- What is your compensation philosophy?
  - Where do you want to be on this continuum?

  - Adequate compensation or competitive compensation?
  - What is the role of current cash compensation, versus cash benefits (e.g., health insurance), versus soft benefits (additional time off), versus deferred compensation in your compensation plan?

Understanding Your Objectives (continued)

- Who will be eligible for various compensation components?
  - The senior/executive leader
  - Members of the executive leadership team (C-suite)
  - Additional levels of leadership
    - What selection criteria will apply?
  - How will your compensation plan be nondiscriminatory?
    - Note that churches enjoy some relief from nondiscrimination testing

Deferred Executive Compensation Best Practices

- Make sure to maximize use of traditional planning tools first
  - Bonus plans
  - Qualified retirement plans (401(k) plans, 403(b) plans, SEP IRAs, SIMPLE, defined benefit pension plans)
  - Less common: nongovernmental 457(b) plans
  - Health insurance benefit plans (post-retirement)
- If necessary, complement traditional planning with nonqualified deferred compensation planning

Maximize Use of Your 403(b) Plan

- Use bonuses to executive to allow them to maximize elective deferrals to their 403(b) plan account
  - For 2023, the maximum elective deferral amount is $22,500
  - For individuals over age 50, an additional catchup amount of $7,500 is permitted
  - Don’t lose sight of the excess benefit transaction excise tax rules for excessive compensation
    - Be sure to have good comparability data to ensure total compensation is reasonable

Maximize Use of Your 403(b) Plan (continued)

- Maximize the employer contribution opportunity
  - The combined limit for employee elective deferrals and employer contributions for 2023 (not including over age 50 catch-up amounts) is the lesser of $66,000 or 100% of actual compensation
  - If an employee is contributing the maximum elective deferral amount ($22,500), an employer can contribute up to $43,500 in additional contributions
    - For nonchurch plans, this may be limited by the nondiscrimination rules
    - For church plans, there is no effective limit on the church’s ability to contribute this amount

Maximize Use of Your 403(b) Plan (continued)

- Make use of the post-retirement 5-year contribution rule
  - An employer may make nonelective employer contributions for up to five years after retirement
  - Depending on the circumstances, these nonelective contributions may be sufficient to satisfy post-retirement income needs

Nongovernmental 457(b) Plan

- A supplemental retirement plan option for nonprofit organizations
- Is on top of a 403(b) plan
- Requires a written plan document
- Does not require nondiscrimination testing
    - This means it can be set up for a single employee or a small group of employees

Nongovernmental 457(b) Plan (continued)

- Permits both salary reduction contributions and employer contributions
  - Combined employer contribution and salary reduction limit for 2023 is the lesser of $22,500 or 100% of compensation
  - The limit is doubled in the three years before attaining normal retirement age
- Contributions are made on a pre-tax basis
  - But FICA tax (or SECA tax for ministers) must still be paid
- No over-age-50 catch-up provision

Nongovernmental 457(b) Plan (continued)

- Not taxed to the participant until the earlier of when made available to participant or distributed
- Number of distributable events, including:
  - Attainment of age 70 ½
  - Severance from employment
  - Unforeseeable emergency
  - Plan termination
  - Qualified domestic relations order
  - Small account distribution

Nongovernmental 457(b) Plan (continued)

- Required minimum distributions required
  - If plan assets not made available before required beginning date
- Rollover to IRA or other retirement plan not permitted
- There is no Roth option
- Plan assets remain the property of the employer and are available to the employer’s creditors in case of default
  - A rabbi trust is commonly used to hold plan funds

Nonqualified Deferred Compensation Plans

- A nonqualified deferred compensation (NQDC) plan is any plan that includes a future payment for current services that is not one of the qualified plans already discussed or a 457(b) plan
- NQDC plans can either:
  - Permit deferral of receipt and income taxation of current earnings, or
  - Contemplate a future payment above and beyond current earnings
- NQDC plans are governed by the Internal Revenue Code section 409A

Nonqualified Deferred Compensation Plans (cont.)

- In the case of deferral of current earnings:
  - Deferred amounts are subject to income tax when later distributed
  - FICA or SECA tax remains currently due and payable
- With respect to promises to pay future amounts, the funds are taxed for both income tax and Social Security/Medicare purposes when there is no longer a substantial risk of forfeiture
  - For non-church plans, this will frequently mean the funds become taxable in a lump sum
  - Church plans have more flexibility

Nonqualified Deferred Compensation Plans (cont.)

- An NQDC plan is an unsecured promise to pay in the future
  - Employees may want some assurance there will be funds available to pay the promised benefits
  - In addition, employees may want some assurance that future boards will not renege on a promise to pay because money is tight
- A “rabbi trust” is the most common technique used to set aside funds to cover NQDC plan promises
  - A rabbi trust is an irrevocable trust designed to receive and hold funds that will ultimately be distributed in fulfillment of an NQDC
  - Rabbi trust assets are effectively off-limits to the employer, but are available to the employer’s creditors in the event of a default judgement

Nonqualified Deferred Compensation Plans (cont.)

- Distributions from the rabbi trust
  - The NQDC can be drafted such that the employee receives:
    - A fixed dollar amount from the rabbi trust in accordance with the promises in the NQDC plan
    - Periodic distributions over a period of time
    - The employee receives the benefit of any investment earnings in the rabbi trust
- An NQDC can be drafted such that any vested and undistributed amounts due are payable to the employee’s named beneficiary or estate

Nonqualified Deferred Compensation Plans (cont.)

- It is important to get competent assistance in the preparation and administration of an NQDC plan
    - Section 409A imposes substantial penalties when an NQDC plan is improperly designed, drafted, or administered

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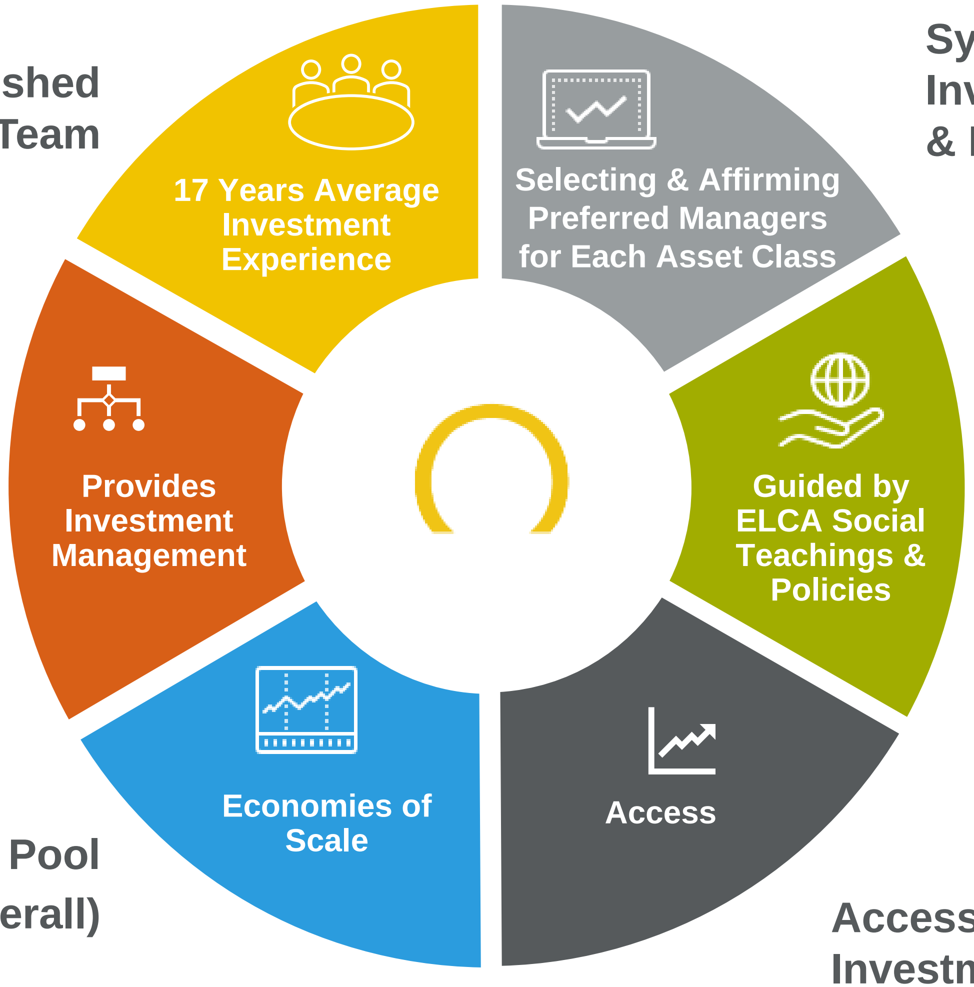

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QUESTIONS

403(b) Plan Educational Resources

- IRS Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations*

- IRS Webpage: IRC 403(b) Tax-Sheltered Annuity Plans

457(b) Plan Educational Resources

- IRS Webpage: IRC 457(b) Deferred Compensation Plans
- IRS Webpage: Non-Governmental 457(b) Deferred Compensation Plans
- IRS Webpage: Comparison of Tax-Exempt 457(b) Plans and Governmental 457(b) Plans

CONTACT

For questions or to request the ***Compensation Philosophy template***, please contact:

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