Pine Crest School

Fort Lauderdale and Boca Raton, FL
PK-12 Coed Day School
2,680 students

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Case Study Focus

Innovative Executive Compensation: Exempt Benefits for Tax-Exempt Entities

Background

Pine Crest School's mission is to develop the character, independence and leadership of each student; to prepare students to meet the global challenges of the future by offering an exceptional academic experience complemented by excellence in arts and athletics; and to build a collaborative, inclusive and open-minded learning community that respects, appreciates and encourages those with diverse cultures, backgrounds, talents, experiences and opinions.

Pine Crest colleagues represent a broad spectrum of experience and cultural heritage, and leadership seeks to add to this diverse wealth of talent. The school is continuously searching for individuals to join their community who are committed to the mission of the school, exceptional in their field of expertise and enthusiastic. At Pine Crest, the growth mindset extends beyond its students. In part, through generous donations made to The Pine Crest Fund, the school is able to facilitate professional learning initiatives in addition to a robust tuition remission program for qualifying faculty and staff.

Context for Executive Compensation Changes

Pine Crest is a large operation supported by an endowment of approximately $89 million, at the time of this report, which plays a significant role in faculty and staff recruitment and retention. Its strong financial position allows its board, Greene and her leadership colleagues, to be forward-thinking and innovative. Thus, some of the executive compensation strategies offered below are new to PK-12 independent schools, but have long been used by colleges, universities and other nonprofit organizations.

Pine Crest's pursuit of strategic executive compensation stems from the challenges faced by schools and organizations both during and after the pandemic in attracting and retaining key talent, the high cost of replacing key employees (often up to 200-400% of annual salary), and the unintentional discrimination that occurs with group long-term disability and life insurance programs due to caps built into those programs. Key employees earning higher salaries may find themselves with disproportionate coverage and inadequate protection compared to their lower-paid counterparts.

Additionally, IRS limitations on retirement programs prevent many key employees from adequately replacing their income in retirement. For employees earning above a certain income threshold, these restrictions can prevent them from fully replacing their income during retirement using employer-sponsored retirement plans alone. As the job market becomes increasingly competitive, offering attractive benefits becomes crucial in securing and retaining top talent.

Challenges of Traditional Executive Benefits

1. **The Cost of Replacing Key Employees**

   Build programs to creatively attract and retain top level talent.

   In any employment environment, attracting and retaining top level talent is challenging. The costs to replace a highly compensated executive is estimated to be 200-400% of the annual salary associated with that position. Considering the competitiveness of the upper end of the employment market, attracting and retaining key employees is of utmost importance; this necessitates offering competitive compensation packages. Schools must find ways to accomplish this while managing their limited resources.

2. **Program Optics**

   Form 990 Considerations and Excise Tax Liability: IRC §4960 of the Tax Cuts and Jobs Act

   Executive benefits in the tax-exempt space can be highly sensitive to public perception. The organization can manage potential sensitivity by keeping executive compensation packages off schedule J of the 990.

   Any compensation paid to the top five compensated executives and any former covered executive of 501(c) companies in excess of $1MM will trigger a 21% excise tax to the company on that excess compensation. Restructuring traditional executive compensation structures such as bonus packages, housing allowances, and 457(f) programs into another form can

keep income off of schedule J of the 990, reduce potential excise tax to the school, give the school back its investment and reduce future tax liability to the executive, giving them a stronger package.

3. **Restricted Savings Opportunities**

   Addressing the unintended shortfalls of qualified retirement plans.

   Whether by plan design or by way of regulator limitations, group benefit plans can cause unintended reverse discrimination against highly compensated employees. The regulatory limits on qualified retirement plans can contribute to shortfalls that decrease the effectiveness of these valuable programs. Maximum contribution rates established by the IRS do not allow executives to adequately replace their income in retirement.

New Executive Retention and Reward Programs

To address these issues, with help from hired consultants at NFP, the school explored a bundle of executive benefit packages, including executive life and disability, the more widely known 457(b) and 457(f) plans, as well as the lesser-known loan regime split-dollar plans. NFP helped the school categorize executive benefit programs into three silos: Benefit Equalization, Recruiting and Retaining, and Retirement Completion. They proposed solutions for each silo to ensure a comprehensive executive benefit package.

A complete bundled executive benefits package may include:

Insurance Considerations

- Executive Life Insurance
- Executive Disability Insurance

457(b)

- Employee elective deferral plan allowing $19,000 of compensation to be tax deferred
- In addition (not in lieu of) qualified plan deferrals

Catch-all 457(f)

- "Catch-all" executive benefit plan for participants not in LRSD
- Apply properly structured vesting schedules to avoid possible excise tax events

Loan Regime Split-Dollar (more follows below)

- Convert compensation expense to corporate asset using loans
- No longer considered compensation and avoids excise tax
- Greater flexibility for distribution to participants
- No substantial risk of forfeiture to the participants
- Organization recovers all costs

More on the Loan Regime Split Dollar (LRSD)

Albeit requiring a lump sum of cash up front, loan regime split-dollar plans offer tax efficiency, distribution flexibility, and personal asset benefits to the employees. The strategy allows designated key employees, such as heads of school, to receive benefits without attracting negative reporting optics or triggering excise tax implications or personal income tax. Furthermore, the plan is balance sheet-friendly for organizations, provides cost recovery through interest and ultimately loan repayment, and can act as an asset rather than a liability if structured as such.

The loan regime split-dollar plan involves the organization using a loan to the employee to fund a life insurance policy with both death benefits and cash value components. The cash value serves as a living benefit, providing flexible retirement income or other distributions to the executive. Upon the executive's death, the death benefit repays the loan and accrued interest to the school in full, and any excess goes to the executive's beneficiaries tax-free. Greene and her school business leadership colleagues at Pine Crest feel this is an effective solution to address the challenges in attracting, retaining and ensuring a secure retirement for key employees while providing tax and financial advantages to both the employee and the school, including tax efficiency, distribution flexibility and avoidance of negative reporting optics and excise tax.

Employee Highlights	Employer Highlights
• **Tax Advantaged Savings and Income** When structured properly, contributions are pre-tax, accumulate tax-deferred, and distribute tax-free • **Distribution Flexibility** No early penalties or required minimum distributions • **Personal Asset** The value of the account is a personal balance sheet item, not subject to NQDC's required substantial risk of forfeiture • **Wealth Transfer** Death benefit component provides tax free proceeds to beneficiaries	• **Mitigate Cost of Replacing Key Talent** Reward, retain and recruit • **Design Control** Eligibility, sponsor contributions • **Reporting Optics** The LRSD structure can help mitigate negative public perception due to 457(f) Form 990 Schedule J reporting optics. • **Excise Tax Alleviation** The LRSD structure can help alleviate excise tax concerns. Any compensation paid to the top five compensated executives and any former covered executive of 501(c) companies in excess of $1MM will trigger a 21% excise tax to the company on that excess compensation. • **Cost Recovery Opportunity** The LRSD structure provides the organization a mechanism to

	recoup the contributions made to the participants, plus interest. • **Balance Sheet Friendly** Certain LRSD structures provide the organization the ability to book the cost recovery component as receivable.

Example Scenario

The scenario involves a retirement benefit plan designed for an executive, aged 52, assuming a retirement age of 65 and a mortality age of 85. The plan offers a single loan option of $3.42 million to the executive, utilizing an interest rate equal to the applicable federal rate published by the IRS monthly. By using this rate, the plan ensures that no taxes or imputed income are incurred.

A whole life insurance policy serves as the engine of the arrangement, financing the loan and accrued interest on it. The organization benefits from a net gain of $5.9 million over time, with approximately $9.3 million being repaid back to the organization by age 85.

From the participant's standpoint, the executive receives an annual retirement income of $105,000 for life, tax-free. At age 85, there remains a death benefit of approximately $9.4 million which will be used to repay the loan to the school. The excess amount, about $83,000, goes to the beneficiaries income tax-free.

Risks of the Loan Regime Split-Dollar Program

1. **Interest Rate Environment**

   The loan regime split-dollar plan utilizes an interest rate equal to the applicable federal rate published by the IRS monthly. However, the interest rate environment can be volatile, and fluctuations in AFR could impact the plan's performance. Higher interest rates may lead to a higher cash outlay for the organization, affecting the executive benefit, while lower interest rates may reduce the organization's potential gain.

2. **Insurance Carrier Risk**

   The plan relies on a whole life insurance policy, and the financial strength and stability of the insurance carrier are crucial. If the carrier faces financial challenges or underperforms, it could affect the policy's cash value and the ability to repay the loan at maturity. Choosing a reputable and financially sound carrier is essential to minimize this risk.

3. **Policy Lapse**

   Policy lapses can occur if the plan is not managed properly or if premium payments are not made on time. A policy lapse would jeopardize the ability to repay the loan and could result in negative financial consequences for both the organization and the executive. Proper oversight and adherence to premium payments are necessary to avoid this risk.

Risk Mitigators

1. **Loan Refinancing**

   The plan allows for loan refinancing, so by periodically refinancing the loan at lower AFRs, the organization can maintain the executive benefit while potentially reducing the cash outlay and interest expense.

2. **Carrier Financial Strength**

   The choice of a financially strong and stable insurance carrier, with guidance from your industry partner(s) mitigates the carrier risk. A reputable carrier with a solid financial track record ensures that the policy's cash value remains reliable, reducing the risk of the policy underperforming or lapsing due to carrier instability.

3. **Whole Life Dividends and Guarantees**

   Whole life insurance policies offer dividends based on the carrier's general assets' performance. The use of whole life insurance and the dividends it generates provide a form of stability in the policy's performance, as these dividends are typically invested conservatively. The policy's guaranteed death benefit also ensures that the loan can be repaid, even if the policy's performance does not meet expectations.

Other Considerations

1. **Single Loans vs. Multiple Loans**

   Organizations have the flexibility to choose between providing a single lump-sum loan or multiple loans to fund the split-dollar plan. While a single loan may be cleaner and more straightforward to manage, multiple loans can be beneficial for organizations with budget constraints, as they can spread the cash outlay over time, making it more manageable.

2. **Recourse Loans vs. Nonrecourse Loans**

   The plan can be structured as either a recourse loan or a nonrecourse loan. In a recourse loan, if the policy's death benefit is insufficient to repay the loan plus interest, the organization has the right to collect the remaining amount from the executive's estate. A nonrecourse loan, on the other hand, absolves the executive's estate from any further obligation beyond the policy's death benefit. Recourse loans may be more favorable to the organization, while nonrecourse loans provide added security to the executive.

3. **Whole Life vs. Indexed Universal Life (IUL)**

   The plan utilizes whole life insurance due to its conservative and stable nature. Whole life insurance policies rely on dividends, which are generated based on the carrier's general assets' performance, providing some protection against interest rate fluctuations. On the other hand, IUL policies are tied to the performance of specific market indexes and may offer higher upside potential but also carry more risk and uncertainty. The choice of whole life insurance aims to provide a reliable and predictable performance for the policy, ensuring a secure executive benefit.