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FINANCIAL GROUP

Executive Benefits: Do You Understand Your Options?

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Financial Wisdom from The Experts at IZALE

Achieving your mission is not possible without the right leadership. You can lay out a compelling vision and foster a culture that encourages and motivates people to action. Culture alone, however, may not be enough. To attract – and keep – the highest performers you need to assemble a total compensation package that addresses both short-term and long-term needs for income.

Short-term compensation – the base salary and bonus – help fuel today's lifestyle. It's important to benchmark those regularly and there's a best practice to doing that; that is a subject for another article.

Only relying on current cash compensation, however, is risky as there's always a bigger checkbook elsewhere. Every employee, especially an executive, needs to plan for the day when current income ends (retirement). Including elements of long-term compensation helps then to both retain and reward your key people. These elements are generally referred to as executive benefits.

Only after you pinpoint the amount of an executive benefit should you then consider what form of benefit to provide. There are three general forms each with its own advantages and disadvantages. Here are examples of how three DCUC members deployed benefits that work for them.

Section 457(f). Based in the mid-Atlantic states, this credit union offers a 401(k) with match as well as a defined-benefit pension plan. Due to limitations on the amount of income that could be considered for qualified plan benefits nearly twenty of their top executives will not receive the intended benefits. The board wanted to offer benefits contingent on staying for the long-haul (much like the pension plan) and given the number of executives involved settled on a Section 457(f) plan.

With a 457(f) the credit union makes a "mere promise" to pay a benefit in the future. No specific asset needs to be purchased. The credit union accrues the future benefit liability by expensing the cost. Benefits will be paid from general assets. The executives must stay until the payment date – voluntarily leaving before results in forfeiture of unpaid benefits. Upon vesting the executive must pay ordinary income taxes on the amount. Under the Tax Cuts and Jobs Act of 2017, if the total compensation (base, bonus, 457(f)) paid to any executive exceeds $1 million in a year the credit union will be subject to an excise tax (currently 21%) on the amount that exceeds $1 million.

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Continued from Page 1

Restricted Executive Bonus Agreement (REBA). Based in the central US, this successful credit union is rapidly growing and needs to retain seasoned executives as well as recruit additional talent. While they could readily absorb the expense of a 457(f), the board wanted a plan that offered better income-tax treatment than a 457(f) yet still had some handcuffs.

Enter a Restricted Executive Bonus Agreement or REBA, which requires the executive to purchase and own a life insurance policy. Life insurance gets special treatment: values grow tax-deferred, distributions can be income-tax-free, and death benefits are income-tax-free. The funding is limited only by the insurance company's underwriting risk tolerance.

Under a REBA the credit union agrees to pay the premiums if the executive remains employed. Each premium payment is a current expense so there is no liability to accrue, and each payment is current ordinary income to the executive. The policy has a restrictive endorsement that prevents the executive from taking distributions too soon. While the executive can be vested in the cash value, certain terminations can cause forfeiture of the policy (thereby providing handcuffs for the credit union). The total cost to provide a REBA with tax-equivalent benefits is 25%-30% less than a 457(f).

Split-Dollar Loan (SDL). Based in the Midwest, this credit union has received several awards for performance and providing member value. The board wanted to recognize senior executives for leading the charge. There was an established 457(f) plan for one of them; while the executive was satisfied with the lump sum payout despite the large income-tax, the excise penalty under TCJA 2017 forced another look at the plan. After a months-long evaluation, the board decided to modify the 457(f) and implement a Split-Dollar Loan or SDL arrangement for the executives.

Like a REBA, SDL requires the executive to purchase and own a life insurance policy. However, the premiums paid by the credit union are treated as a loan to the executive. The typical design has the credit union advancing 7-10 years of premiums in the first year, meaning the funding required can be significant relative to net worth. The credit union will recover the premiums with interest no later than death. To secure recovery, the credit union takes a collateral assignment in the policy.

Split-Dollar Loan is more complicated than either a 457(f) or a REBA, however, the total cost to provide a SDL is ultimately zero given the built-in recovery. It's critical that the board understand that the collateral value may be less than the outstanding loan balance (especially in the early years); how that difference is treated may impact the credit union's financials.

Each client was able to solve their primary objective – helping to attract, retain, and reward the right leadership. The difference was in the approach – each evaluated each form and chose what checked the most boxes for them (and their executives).