

Executive Retirement Programs at River Branch General

A Guide Into a Safe Harbor for Not-for-Profit Hospitals

By William J. Bowden, Thomas P. Flannery and Michael T. Horton

Since 1990 our fictitious River Branch General Health Care System has grown from the initial merger of two century-old hospitals in downtown Pleasant Valley to 15 hospitals serving as many communities on both sides of the Mississippi River. Today, the health care professionals have many reasons to hail River Branch as a well-run, well-regarded health care system, a merger and acquisition success story.

Among those reasons are senior management's recent patient care and quality initiatives, the system's conversion to a system-wide IT platform that handles both finance and HR transactions and a new bond offering to finance construction of a new facility in Middleville, the underserved but growing suburb of Pleasant Valley.

In the last several years, River Branch General has experienced an increase in reputation within the medical and general communities as the best place to admit patients and to receive superior medical care. On the administrative side, billing errors have decreased and the pace of cash inflow for medical services rendered has increased. In short, there was widespread recognition of River Branch's prospects for growth and its increasing stature as a community leader.

Now River Branch's trustees and management team must address the challenges of retaining its current senior managers while grooming or recruiting their successors. The unexpected departure of Tom Folder, the CFO, has made doing so a clear priority. He was on the management team and — at 42 — its youngest member. With his departure after only two years on the job, the team's average age rose to 58 and its average length of service to 15 years.

Those numbers and one more — six months left on the current contract of the hospital's charismatic CEO, Dr. Vera Light — add up to a dilemma for the trustees. The CEO has made it clear that this upcoming three-year contract will be her last and that she is uncomfortable with the adequacy of her retirement benefits under her current contract. She is also interested in taking care of the key members of her management team so that they are able to retire in comfort as well. The board of trustees has asked the team to evaluate how an executive retirement plan can ease their transition to retirement and allow the Board to plan for a smooth succession.

INTRODUCTION

Trustees at not-for-profit health care organizations must approve and maintain the executive retirement programs for the organization. Executives want a program that will allow them to focus on running the organization rather than planning for their needs in retirement.

This white paper clarifies the process by helping trustees and executives think through the fundamentals of executive retirement packages. The clarification comes in two parts: what trustees and management must know in order to make informed plan design and funding decisions about executive retirement programs and what they must do when designing and approving these programs.

PART ONE: WHAT TRUSTEES AND MANAGEMENT MUST KNOW Start with the Basics

The community it serves and its employees are obviously stakeholders in any hospital. However, the stakeholders most closely involved in developing an executive retirement program for any not-for-profit organization including a hospital are its trustees and management. Their first step is to determine the goals of implementing such a program. Executive retirement plan goals typically include:

- Providing adequate retirement benefits to executives whose qualified retirement benefits are significantly curtailed by Internal Revenue Service (IRS) limits.
- Planning for orderly succession in the organization.
- Attracting and recruiting talented senior management.
- Retaining talented senior management through the use of "golden handcuffs."

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- Delivering benefits in a tax-effective manner for the executive.
- Delivering benefits in a cost-effective manner for the hospital.
- Ensuring that promised benefits are securely funded.

Let's be clear. Every trustee and senior manager involved in developing a retirement program ranks these goals in order of importance. We should assume that their rankings differ. To reconcile those differences, a skilled third-party facilitator often takes management and trustees through an open discussion using a group decision-making tool such as Buck's Q2 FusionSM. The objective of the process is to answer the following three questions.

1. What is the appropriate level of retirement benefits?
2. At what age should the benefits become available to the executive?
3. What type of plan is the most appropriate funding vehicle?

Then Do the Reality Checks

But before we answer these three questions, we need to do four reality checks. None of these programs can be designed and implemented in a vacuum. In a not-for-profit environment, trustees must consider several issues in constructing a reasonable retirement program that is also tax-efficient. Those issues, discussed below, include all manner of regulatory constraints.

1. An executive's retirement income is a component of his or her total compensation and benefits, which is subject to a "reasonableness test" imposed by Section 4958 of the Internal Revenue Code (IRC). Failure will trigger severe financial penalties, both for the institution and for any trustee or executive who receives compensation and benefits determined to be unreasonable. (See some of the fine print on Intermediate Sanctions for Tax-Exempt Organizations on page 6.)
2. In testing the reasonableness of not-for-profit executive retirement benefits, the IRS recognizes that the retirement benefit qualified plans can provide is relatively low when compared to an executive's pre-retirement compensation. For that reason, the IRC sanctions use of deferred compensation plans as a means of providing supplemental benefits to executives. Any retirement income executives receive from these deferred compensation plans — 457(b)

and 457(f) (See Not-for-Profits; Doing Retirement Plans by the Numbers (and letters) on page 3.) — as well as what they may receive from the employer's qualified plans is tested for reasonableness and reported as executive compensation on Form 990.

3. A number of exotic retirement programs have been developed in attempts to avoid the substantial risk of forfeiture restrictions and retirement benefit limits that IRS regulations impose. Examples include split dollar life insurance policies, severance plans and "mutual fund option plans." Many of these programs claim tax and/or security results based on interpretations of the regulations that assume ambiguity means the same thing as acceptance. Invariably, the IRS issues clarifying regulations that detail how such programs do not conform to Congressional intent.
4. Often, additional retirement benefits can be provided to executives through the qualified retirement plan. These additional benefits must satisfy the IRS prohibition against discriminating in favor of Highly Compensated Employees in the qualified plan. However, if these numerical nondiscrimination tests are satisfied, qualified retirement benefits represent the safest, most tax-effective vehicle.

First Question:

What is the Appropriate Level of Executive Retirement Benefits?

To answer this question, we need to consider an executive's other sources of retirement income. These include retirement benefits the hospital currently will provide through qualified plans, other retirement benefits vested and payable by other employers and Social Security. The best framework for determining the appropriate retirement benefit to be provided to executives is the replacement ratio, expressed as follows:

*The annual retirement benefit from all sources
expressed as a life annuity*

*Annualized average pay during the period
immediately preceding retirement*

Often trustees can at least partially answer the question "What is an appropriate — or fair — retirement benefit?" by comparing what a specific executive's replacement ratio would be without benefits from any non-qualified programs to the replacement ratio provided to rank-and-file career employees.

In this comparison, the executive's replacement ratio will tend to be lower for two major reasons.

- IRS regulations impose limits on the pay and benefit amounts that can be recognized in qualified plans.
- For more highly paid employees such as executives, the fact that the income replacement "value" from Social Security is relatively low tends to lower the resulting ratio.

Unfortunately, an ideal retirement program that works for one executive may not work for all or any other covered executive. One size does not fit all. The fact is that executives are likely to have arrived at the current point in their careers by quite varied, often circuitous routes. For sure, some will arrive after a long career at a single organization but others will have been at many organizations making it difficult for them to achieve long service periods (and resulting vesting of retirement benefits) at any one organization. Some will be making a mid-career entry; others will be late-career entrants. (See Building the Replacement Ratio on page 4.)

The competitive landscape is another important consideration when answering the "What is appropriate?" question. We need to look to what other similarly situated organizations are providing to their executives. The competitive position of the hospital's current and proposed program is critical information.

But there's a hitch. Not only do "fair" retirement programs come in many sizes and shapes, their beneficiaries often bring with them issues related to the timing of benefit payments. Let's return to River Branch for some real-life fairness and timing considerations that will frame the answer to the second question.

Second Question:

When Will Executive Retirement Benefits be Made Available?

It's now four months until the end of CEO Light's contract. In the meantime, River Branch has worked with Buck to develop a new outline of reasonable compensation for the CEO, including a proposal to adopt a new retirement program. The amount of retirement benefit has been determined as 60 percent of final pay, but negotiations continue on when the retirement benefit can be paid and over what period of time the full 60 percent benefit will accrue. The trustees would like to see no benefit paid if the executive leaves prior to the end of her three-year contract. The CEO feels she should have the option to retire as early as age 62, but is

concerned that if the benefits vest at age 62, she will need to pay taxes on the considerable amount set aside in the retirement plan, even if she continues to work until age 65. Other significant plan design considerations remain to be negotiated.

Not-for-Profits: Doing Retirement Plans By the Numbers (and Letters)

Not-for-profits, like most employers, refer to the various benefit plans for which their employees are eligible by the numbered section (often followed by a letter) of the IRC that sanctions those plans. In addition, the annual filings on executive compensation which the IRS requires of not-for-profits, are also typically known by their numbers. Some of these numbered plans and forms are defined below.

457(b)- Deferred compensation plans eligible for tax treatment under 457(b) allow employees of sponsoring organizations to defer income tax on retirement savings into future years. The maximum annual deferral is \$13,000 in 2004, \$14,000 in 2005, \$15,000 in 2006 and indexed with inflation thereafter. Amounts contributed to 457(b) plans are vested without being taxable to the participant. Nonetheless, assets in the plan are considered assets of the sponsor in the event of bankruptcy.

457(f) -Deferred compensation plans under IRC 457(f) have no caps on the amount of benefit that can be provided, but are taxable to the executive upon vesting. Regardless of whether the benefit has vested or not, assets of the plan are considered assets of the sponsor in the event of bankruptcy.

Form 990 - This outlines the activities and financial status (including compensation to executives) of tax-exempt organizations. These organizations must file this form with the IRS each year. Interested parties among the public rely on the Form 990 as the primary source of information about a particular organization. How these interested parties perceive an organization may be, in large part, determined by the information provided in Form 990.

Building the Replacement Ratio

Doing this successfully requires trustees to consider all sources of retirement income and to develop reasonable assumptions as to what will occur in the future regarding:

1. Future base pay increases
2. Actual incentive payouts
3. Actual investment return
4. Cash balance interest credit
5. Actuarial equivalent basis and interest credit basis for cash balance plan per plan document
6. Future Social Security or plan changes
7. Retirement age
8. Actual cash values from life insurance and deferred income account balances
9. Actual elections regarding deferred income accounts
10. Accounting and funding considerations

Meanwhile, it's now eight months since CFO Folder left River Branch. Three, well-qualified candidates have recently emerged as his replacement. Each would bring different strengths to the position and, given the wide disparity in ages (25 years) and levels of current vesting in retirement benefits from previous employers (ample to none), very different requirements for retirement benefits.

At this point, the challenge for management and, ultimately, the trustees, is twofold: to assess, first, the total compensation "costs" to the organization of hiring each candidate and, second, the reasonableness according to IRC Section 4958 of those costs given industry practice and comparable costs of hiring the other two candidates.

PART TWO: WHAT TRUSTEES AND MANAGEMENT MUST DO

We have reached a critical point in the story at River Branch. Trustees and management, either separately or together, now need to do the following:

1. Management must propose — and trustees must approve — a total rewards philosophy that reflects the organization's specific business realities and its target market for executive talent.

2. Since trustees have final approval over any executive retirement plan that management proposes to them, management must keep trustees informed as those proposals are being developed. Before approving the new retirement program, trustees will need to understand: (a) the annual cost of the revised retirement plan, (b) the estimated total cost to the organization until the affected individuals retire, (c) the cash flow requirements and (d) cost projections under a range of economic scenarios.
3. Trustees and management should make sure all their executive compensation program decisions are in line with current market practices. Doing so provides evidence to respond to a possible future claim that their program doesn't pass the reasonableness test.
4. The target income replacement ratio (for instance, 60 or 70 percent of the final three years' average) that reflects the market practice and is reasonable for the position should be the first design detail trustees address. Next, details such as the age at which the retirement benefit becomes available to the executive, what happens for death, disability or termination (separately for voluntary and involuntary terminations) need to be addressed. Depending on the group of executives to be covered, all of these factors can vary from person to person.
5. Management and trustees must consider the pros and cons of providing defined benefit (DB) or defined contribution DC-type retirement benefits. In executive retirement programs, this question boils down to who will make the investment decisions and take the investment risk: the hospital or the executive? The Investment Committee of the Board invests the assets of a DB plan and benefits when those investments outperform expectations and makes up the difference when they under perform. The executive makes the investment decisions in a DC plan and accumulates greater or lesser retirement benefits depending on how those investments perform.
6. Be sure that all documentation (such as the plan document's financial projections, trust documents, etc.) is complete and filed and that all parties (management, consultants and the Compensation Committee) review the program at least every three to five years.

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7. The type of plan and funding vehicle must be determined. Often, it makes sense to provide a part of the executive retirement benefit through employer contributions to a 457(b) plan. Because of IRS restrictions on the amount of contribution that can be made to the 457(b), the benefits eventually accrued will constitute only a part of the executive retirement income. The trustees might determine that the 457(b) plan should not involve employer contributions and the 457(b) is only made available as a supplemental savings plan (after all, 50 to 60 percent replacement does not necessarily provide everything the executive needs for comfortable retirement and the 457(b) is a tax-effective approach for the executive to utilize in saving for retirement). The decision on which funding vehicle is appropriate involves complex analysis and is discussed below.

Third Question:

What Is the Most Appropriate Retirement Program Funding Vehicle?

One of the more critical decisions management and trustees must make is how to fund the plan they propose and approve. Until recently, Split-Dollar Life Insurance (SDLI) and so-called “Mutual Fund Option Plan” products have been popular funding vehicles. Some “grand-fathered” Mutual Fund Option Plans remain, but these have not been offered since the IRS published final regulations on hedging transactions in March, 2002 (T.D. 8985, Regs. §1.1221-2, March 10, 2002).

As a practical matter, that leaves SDLI and 457 plans at the top of list for most not-for-profits choosing a funding vehicle for executives’ non-qualified retirement plans.

Although in the past many health care organizations have purchased SDLI to informally fund supplemental executive retirement plans or other nonqualified benefits, many of the programs are no longer efficient or meeting expectations.

Typical comments and questions heard from many split-dollar owners and sponsors include: “Our plan is not performing as expected. How do we reconcile performance shortfalls? How can we improve performance? Are there alternatives that are simpler/more efficient and fit within the new regulatory environment?” Nevertheless, SDLI does have advantages in certain situations. The chart below compares SDLI to 457 plans in two categories: how they help employers actually meet the previously stated objectives of an “ideal” plan and how they claim to meet those objectives.

A Happy Ending in River Branch’s C Suite

The trustees have negotiated a second (and final) three-year renewal contract with the CEO, Dr. Light. They (and their outside consultant) believe the contract:

- Meets the criteria of reasonable compensation and
- Is “doable” from a funding perspective.

DIFFERENCES BETWEEN PERCEPTION AND REALITY

	SDLI		457	
	As Sold	Reality	As Sold	Reality
Characteristic	Yes	Not Bullet-proof	No	Almost as good as SDLI
990 Impact	Negligible	Low, but has increased under new regulations	Significant	Significant
P&L Impact	Low	Low — but can be high if plan fails	Significant	Significant
Cash Flow Requirement	Not Applicable	High	Better than SDLI	Better than SDLI
Tax Effective	Very — low tax going in, tax free coming out	Questionable, depending on design	Like a pension: tax deferred going in, taxable coming out	Like a pension: tax deferred going in, taxable coming out
Performance Risk	Low	Substantial	Same as for a 401(k) or 403(b)	Same as for a 401(k) or 403(b)

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Intermediate Sanctions for Tax-Exempt Organizations

Section 4958 of the IRC allows the IRS to impose financial penalties on managers of tax-exempt organizations, such as not-for-profit hospitals and health care systems, if they engage in excess benefit transactions. The applicable regulations are called Intermediate Sanctions.

A manager is an officer, director, trustee or individual having the power or responsibility similar to those of an officer, director, or trustee regardless of title. An excess benefit transaction can occur when the disqualified person's compensation (including retirement benefits) is considered above fair market value or is unreasonable. Among others, a disqualified person is an executive officer or board member. They must repay the excess benefit plus interest and penalties.

Any organization managers who approve a transaction they know constitutes an excess benefit are also subject to a penalty of up to 10 percent of the excess portion of the excess benefit (up to \$10,000 per transaction). If the disqualified person is also an organization manager, the 25, 200 and 10 percent excise taxes could be imposed.

If organization managers rely on a reasoned written opinion from an appropriate professional (i.e., legal counsel, certified public accounting firms with expertise in relevant tax matters, independent valuation experts who meet specified requirements), their participation in the excess benefit transaction will not be considered "knowing" and therefore, they are not subject to the excise tax.

Compliance Considerations

We recommend that tax-exempt organizations take the following six action steps:

1. Identify all disqualified persons and organization managers for the not-for-profit and set up a system for independent review of compensation and performance.
2. Form and educate an independent compensation committee of the board of directors.
3. Review or develop organization's conflict of interest policy.
4. Determine competitive remuneration levels for all disqualified persons through an independent compensation consulting firm.
5. Document process and rationale for determining competitive compensation and recommended compensation levels.
6. Review and update competitive compensation biannually or when appropriate (e.g., when preparing a new employment contract).

As for Dr. Light herself, her new contract gives her the comfort level about the adequacy — and tax effectiveness — of her retirement benefits that she felt she needed. Furthermore, she's satisfied that the trustees were willing and able to meet her other objective: restructuring the executive retirement program so that key members of her management team will also be able to retire comfortably at the end of her next contract if they choose to do so.

The trustees also worked with their outside consultant to add retirement program provisions flexible enough to attract and retain the new executive talent that the hospital needs. Specifically, provisions can be customized enough to be attractive to any of the three candidates being considered for the CFO's position.

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