WHAT IS "DEFERRED COMPENSATION?" AND WHY DO SO MANY HEADS HAVE IT OR WANT IT?

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Deferred Compensation is a method that allows heads to save more for retirement or other needs than they can save through 403 (b) or 401 (k) retirement programs. Contributions may be made by both employer and employee.

1. The Usual Suspects: Traditional Retirement Programs

Normal retirement programs have a "cap" on how much an individual can shelter for tax purposes and how much the employer may put into that same retirement plan. If a school or individual passes that "cap", it is quite possible that certain anti discrimination provisions within the tax law will have been violated. The anti-discrimination provisions require that an employer not pay more for the retirement of higher paid employees than for lower paid employees.

1. The "Other" Approach

The advantage to non-qualified deferred compensation plans is that they are NOT subject to these limitations. A head of school earning $250,000 may shelter $100,000, for example, and the School may contribute as well. Such sheltered funds belong to the SCHOOL, not the head, but only UNTIL the head leaves the employ of the school by retiring, quitting, being fired, becoming disabled or dying.

During these years, the funds grow in an investment plan, the strategy of which has been decided upon in advance by the head and the school. The funds may be invested as part of the school's endowment portfolio, or they may be invested by another outside party who has a keen interest in the head's well being. In either case, the money belongs to the SCHOOL, until the head departs.

1. Why Is This Allowed?

Funds in a non-qualified deferred compensation plan are SUBJECT TO SUBSTANTIAL RISK OF FORFEITURE. That is the condition under which the IRS allows such plans to exist. For independent schools, there are several risks, but in most cases these are minimal:

1. Bankruptcy or serious financial stress. If the School is at risk of closure or in serious financial straits, a plan of this sort is not a wise choice. The head becomes simply one of many creditors in line seeking access to the school's financial resources in order to obtain his "deferred" piece. Our firm has yet to see one of these bankruptcy events occur.
2. Dismissal due to moral turpitude, gross misconduct or illegal behavior. This is NOT defined as dismissal due to disagreement over job performance. Most tax attorneys indicate that if a board attempts to deny deferred compensation as a result of a "falling out" between the parties, the head might sue, and would probably win the resources in the deferred compensation plan AND the earnings on those funds.
3. Breach of contract. This might mean jumping to a neighboring competing school or simply not giving the board adequate and/or stated notice of departure, as required by the contract.

Denying the deferred compensation funds for reasons stated in numbers 2 and 3 above would be the decision of the board at the time. Some, all or none of the money might be denied.

The funds added by the head, as well as earnings from those funds, as part of a voluntary salary reduction plan, normally would NOT be subject to substantial risk of forfeiture except for the first reason: bankruptcy.

1. Who Has These Plans?

Some ninety percent of the heads of well known established independent schools nationwide today have deferred compensation plans one kind or another. These are almost always under section 457 (f) of the tax law and include: Split dollar life insurance policies, rabbi trusts and the most common, "unfunded" funds (really almost always funded). Split dollar policies are under scrutiny today because they are viewed as a poor investment for the school and head, and also questionable in terms of their intended purpose. Many nonprofits with such split dollar policies have been audited recently.

The amount of money contributed by heads to these deferred plans varies with the ability of the head to do with less cash today in order to have more available for the future. However, many heads are sheltering $10,000 to $100,000 a year over and above their 403 (b) TIAA/CREF plan tax shelters and IRA shelters.

The amount of the schools' contributions may vary from as little as $3,000 annually to over $150,000 annually. Littleford & Associates keeps accurate, confidential records of these amounts, as part of our overall compensation review work for boards. The firm can be retained ONLY by the

board (through its chair) and does not work for individuals nor does the firm provide counsel and advice to individuals.

When the money is withdrawn upon a head's departure, the risk of forfeiture provision ends, and the money is subject to taxation (at regular income tax rates) at that time. However, there are several ways to spread out the tax impact over time as well as some creative ways to assist with a housing purchase, thus further reducing tax liability.

The boards of over 1250 schools, foundations and nonprofit educational agencies have retained Littleford & Associates to assist with the review of the compensation and/or evaluation of the head/director.

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