Healthcare Post-Obamacare

The Coming Dramatic Shift in Talent: How Healthcare Must Prepare

An Informative White Paper for Healthcare Delivery Organizations

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Over the last several years, we have lived through the headlines of the Patient Protection and Affordable Care Act (PPACA or Obamacare) and its impact on healthcare in the United States. And the story has been nothing short of contentious.

Let's first review the essential features of Obamacare:

- Everyone in the United States is required to carry healthcare insurance. In reality, only tax payers do since there is no way to force healthcare insurance on illegal immigrants;

- Those who can't afford it are still required to carry it, and will be subsidized by those who can afford it; and, in some states like California, those who can't afford it can still walk into an emergency room and receive free care regardless of ability to pay. In fact, the ER is the free primary care source for this demographic;

- Those who want to be especially proactive and ensure as much of their health as possible will be penalized at their employer level by the Cadillac Tax[1].

So, we essentially have a government-mandated floor and ceiling on consumer payment for healthcare insurance in the Obamacare world. Taxpayers can't pay zero, and they can't pay too much. After the Supreme Court's recent decision upholding this legislation, the dust seems to have settled. *But has it?*

In 2014, it is estimated that up to 32 million additional people will receive health insurance coverage through the PPACA, granting them greater access to the healthcare system[2]. As a result, there is an instant influx of new patients. This development occurs at the same time that many Baby Boomers are turning 65 and becoming Medicare eligible, at a rate of 10,000 per day. No one knows for sure what the true patient volume increase will be, but everyone agrees that it will tax our current healthcare delivery system.

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[1] Scheduled to take effect in 2018, the "Cadillac Tax" of Obamacare is a 40% non-deductible excise tax on employer-sponsored health coverage that provides high-cost benefits. Source: http://www.cigna.com/aboutcigna/informed-on-reform/cadillac-tax

[2] Source: http://www.beckershospitalreview.com/hospital-physician-relationships/coming-soon-32m-new-patients-now-is-the-time-to-assess-your-affordable-care-act-staffing-needs.html

Doctor Shortage

Facing a well-publicized physician shortage, our already overburdened healthcare system will have to evolve and innovate to meet everyone's needs without creating long wait times, stressed staff and unhappy, unhealthy patients. As a service provider in the healthcare staffing industry, we often hear from clients about their struggle to prepare. After all, physicians aren't made or recruited overnight. [3]

In this paper, we will review the impact of Obamacare on an already talent-challenged healthcare industry and suggest remedies including:

- Demographic shifts in the United States population
- The new economics for healthcare providers and shifting the costs of healthcare
- The current high cost of physician turnover

As well, we will draw upon some time-proven best practice solutions from our decades in the executive benefits industry to help healthcare providers triage the situation.

Trendline: Demographic Shifts in the U.S.

Number of Insureds

Now that everyone must be insured, it is expected that Obamacare has increased the insured population by 32 million people.

Number of Healthcare Professionals

According to Dent Research, the U.S. will be short 90,000 physicians by 2020 and will experience a 36 percent shortage in the supply for nurses.

[3] Source: http://www.beckershospitalreview.com/hospital-physician-relationships/coming-soon-32m-new-patients-now-is-the-time-to-assess-your-affordable-care-act-staffing-needs.html

Number of People in the United States

Let's look further at how demographics affect this supply and demand dilemma:

Baby Boomers, 75 Million People[4] (born 1946-1964)[5]

- The 75 million-strong Baby Boomer generation is adding 10,000 aging 65-year olds to the population every day until 2030[6].
- Older people use more healthcare.
- Just as the U.S. population is made up of a large portion of aging Baby Boomers, so is the healthcare field.
- For the next 20 years, Baby Boomer physicians and nurses will slow down, retire, or otherwise leave the healthcare industry, exactly when the Baby Boomers use more healthcare.

Generation X, 58 Million People[7] (born 1968-1979)[8]

- Gen Xers, also known as the "baby bust" generation represent only 16 percent of the U. S. population, too small to support the aging Baby Boomers and to drive consumer spending.

Millennials, 83 Million People[9] (born 1982-2000)[10]

- There are 83 million Millennials in the U.S., coming of age and adding to the consumer-driven economy.
- This generation is more cautious and, as a whole, has not yet reached the prime consumer spending stage of their lives, except in entertainment and technology.
- Millennial physicians gravitate towards specialties and medical careers with better work-life balance; this group has some of the highest college debt load of any generation.

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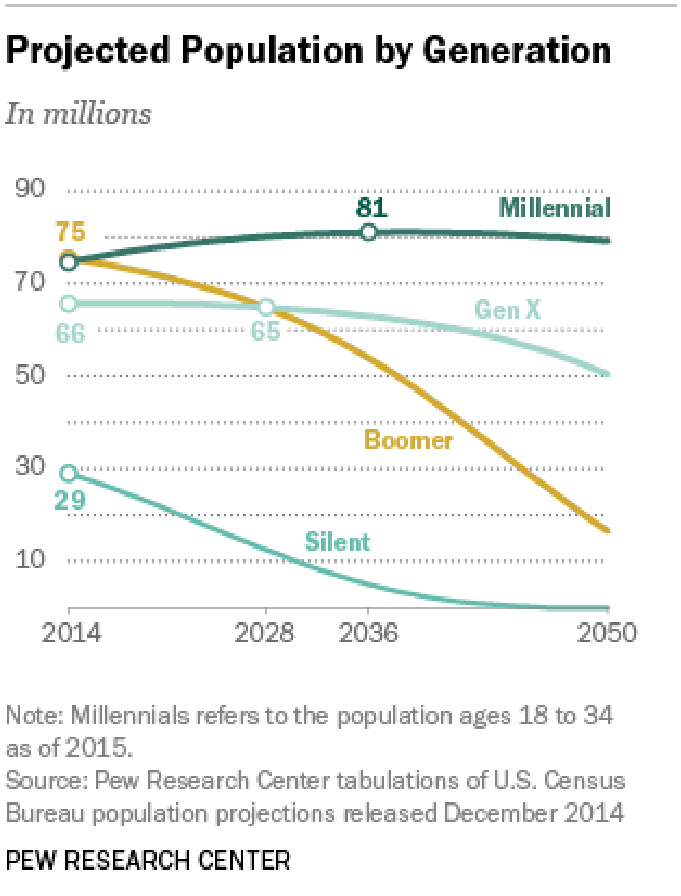
[4] Source: https://www.census.gov/newsroom/press-releases/2015/cb15-113.html
[5] Source: https://www.census.gov/population/age/publications/files/2006babyboomers.pdf
[6] Source: http://pewresearch.org/pubs/1834/baby-boomers-old-age-downbeat-pessimism
[7] Source: https://www.census.gov/population/foreign/files/cps2010/T4.2010.pdf
[8] Source: https://www.census.gov/pred/www/rpts/Generation%20X%20Final%20Report.pdf
[9] Source: https://www.census.gov/newsroom/press-releases/2015/cb15-113.html
[10] Source: https://www.census.gov/newsroom/press-releases/2015/cb15-113.html

Take a look at this chart to see the demographic shift from 2014-2050 across generations.



What does this mean in an Obamacare world? Simply put, there will be more insureds, more aging people, and fewer primary care physicians and nurses to treat them.

Trendline: The New Economics for Healthcare Providers
Shifting the Costs of Healthcare

Financial pressures are causing a growing number of U.S. doctors to leave private practice for hospital employment, according to a new report by Accenture[11].

- Only one-in-three physicians will remain independent by the end of 2016, Accenture predicts. The number of independent physicians has declined over the last several years, from 57 percent in 2000 to 49 percent in 2015, according to the Accenture report. The firm further predicts that next year this number will drop again to 33 percent. This decline represents a ten percent drop from Accenture's 2012 report. Thirty-six percent of physicians cite reimbursement pressures, and 23 percent gave overhead costs as the reason for departure.

- More than a quarter of independent doctors (26 percent) choose not to accept Medicaid as payment for services, according to the report. Another 15 percent are opting out of health insurance plans and three percent out of Medicare.

- Other independent physicians are experimenting with low-staffing models. Twenty-two percent are reducing support personnel, and 21 percent are extending office hours.

- Independent physicians are creating new business models to remain competitive. Nearly one-fifth of those surveyed participate in accountable care organizations (a healthcare organization with a payment and care delivery model that seeks to tie provider reimbursements to quality metrics and reductions in the total cost of care for an assigned population of patients), and seven percent align to patient-centered medical home models.

- One-fourth of physicians is considering ancillary or subscription-based services to generate new revenue streams over the next three years.

In the midst of all this movement, it is expected that cost savings that strive for Six Sigma and Lean methodologies will be applied even further to the healthcare industry. We can expect that patient work will be pushed down from physicians to physician assistants, nurse practitioners, and medical assistants to save on cost.

[11] Source: http://www.healthcarefinancenews.com/news/doctors-leaving-private-practice-droves-joining-hospitals-report-says

Outsourcing billing, back office, and the reviewing of scans and x-rays will continue to be moved to other lower cost labor pools offshore. Internet technologies such as FaceTime and Skype will enable medicine to be practiced remotely, without the expense of offices and physical locations. Physicians, physician groups, and hospitals will consolidate operations to achieve economies of scale.

Hospitals

Medicare reimbursements are now tied to simultaneous improvements in both processes of care measures and patient experience. Due to penalties now imposed for not making improvements, hospitals risk losing 1.5 percent of their Medicare reimbursements in 2015, if improvements are not in place. By 2017, the cut will grow to two percent, equating to millions of dollars for an average hospital[12].

This new paradigm of patient experience, coupled with the costs of Obamacare, and of healthcare increases, in general, are **driving organizations to align physician compensation with metrics called "outcomes-based reimbursement methods."**

What this means for physicians is the lower their patient re-admission rates and the higher their patient experience, the more compensation they earn. But some theorize that the whole idea of physicians "sharing risk" under contracts based on outcomes and capitation tend to disincent physicians from working hard. The game then becomes *"what is the least amount of effort needed to keep being paid?"* Working extra hard and going the extra mile is no longer compensated.

Physician Groups and Concierge Medicine Networks

To lower costs by economies of scale, physicians affiliate with networks and physician groups. This trend will likely accelerate as the costs of running a single-physician practice continues to grow

[12] Source: https://hbr.org/2015/09/what-has-the-biggest-impact-on-hospital-readmission-rates

brought about by increased billing complexity, reduced reimbursements, and the fact that baby boomer physicians want to reduce work hours.

In a move to return to a house-call approach to medicine, physician practices are adopting a higher-cost membership model. This model calls for personalized healthcare through health and wellness goals and one-on-one coaching of patients by concierge doctors. Single physicians shift from 2,000 or more patients in a turn-and-burn care model to caring for 600 or fewer patients who pay an annual membership fee for the extra care. This trend provides physicians with the privilege of doing more quality work for fewer patients.[13]

Trendline: The High Cost of Physician Turnover

A recent Association of Staff Physician Recruiters (ASPR) survey[14] shares the following:

- More than 70 percent of searches conducted last year were for practices owned by hospitals or health systems. This aligns with the fact that many healthcare providers are transitioning to coordinated care models like patient-centered medical homes and accountable-care organizations.
- There is fierce competition for primary care providers—the same ASPR survey showed the top five most heavily recruited specialties and positions were family medicine, hospitalist, nurse practitioner, physician assistant and internal medicine.
- The median days to fill a physician vacancy was 155 across all physician specialties (222 days on average) compared to a median of 120 days (208 days on average) a year prior.
- The median time to fill a primary care vacancy was 151 days (up from 125 days). For advanced practice providers, the average recruitment time remained 90 days.
- **The cost to an organization for a physician vacancy is high, at $587,598 for a six-month vacancy and $1,076,090 for a 12-month vacancy:**

[13] For more information on the concierge medicine model, see the article "How Physicians Actually Make Money These Days" at http://nymag.com/scienceofus/2015/06/how-physicians-make-money.html
[14] Source: http://www.aspr.org/?696

COST OF PROLONGED VACANCY		
Sample Calculation	**12-Month Vacancy**	**6-Month Vacancy**
Vacancy:		
Annualized revenue loss per FTE	$990,000	
Annualized revenue loss per FTE X 50%		$495,000
Recruiting cost:		
Sourcing	$10,000	
Professional fee and sourcing		$30,000
Interview cost x 5.3 Interviews Including travel, entertainment and "manpower"	$31,090	
Interview Cost X 3 Interviews Including travel, entertainment and "manpower"		$17,598
Signing bonus	$30,000	$30,000
Moving cost	$15,000	$15,000
Totals:	**$1,076,090**	**$587,598**

Medical groups reported an average turnover rate of 6.8 percent in 2013, unchanged from 2012, according to the 9th annual Physician Retention Survey from the American Medical Group Association (AMGA) and Cejka Search. The survey also reported turnover of 9.4 percent among advanced practice clinicians, which includes physician assistants and nurse practitioners[15].

The opportunity cost and hard costs of physician turnover are significant. With the shortage of physicians trend coming upon us, these costs will certainly increase.

With all this, medicine will still rely on the experience, education, and professional training of expert physicians. The expertise of a highly trained physician helping to diagnose and treat disease has been and will always be the cornerstone of healthcare.

[15] Source: http://www.sciencedaily.com/releases/2014/08/140821115632.htm

Remedies for the Talent Shift

The demographics in the U.S. are shifting and will continue to shift over the next 30 years. Like

the sun rising and setting daily, we cannot change the population flow. But, with some strategic thinking and best practices, we can bring to the healthcare industry some solutions and approaches to help them face their challenges proactively and head on.

Capitalism in the United States faces constant economic and market challenges. For decades, Fortune 500 organizations have experienced and had to deal with regulation, cost cutting, consolidation, and other large shifts to stay competitive. The public disclosure of these organizations, as well as our decades of experience serving them, provides a deep knowledge base for us to pull from to propose potential solutions to the talent shift in healthcare.

From a Becker's Hospital Review article[16], the following questions can help you start discussions that will help you frame your new and improved strategy and develop the action plan you need to be prepared:

Determining Need

- What are the demographics of your patient population? What percentage are over 65 or turning 65 in the next ten years? Can you determine what your payor mix will look like after the PPACA fully implements?

- Have you determined the volume increase your facility or system may experience by looking at current rates of uninsured in your population?

- Are you located in a healthcare shortage area?

[16] Source: http://www.beckershospitalreview.com/hospital-physician-relationships/coming-soon-32m-new-patients-now-is-the-time-to-assess-your-affordable-care-act-staffing-needs.html

- Have you analyzed the incentives within the PPACA to determine what can help you better prepare for an increase in new patients?

Physician Recruitment/Retention

- What incentives (loan pay down, housing allowances) are you using to recruit physicians?

- On average, how long has it taken you to recruit full-time physicians over the past three years? Have you broken this down by specialty?

- Do you currently use advanced practice professionals in your staffing model? In what roles do they serve, and are you using them to the extent you can as governed by state laws? How long does it take you to recruit physician assistants or nurse practitioners?

- Do you know the short and long-term plans of your current physician staff? What percentage are planning to retire or cut back over the next five years? Can you incent them to stay?

- Are you using locum tenens providers to ensure your employed physicians can take time off to recharge and avoid burn out?

- Have you looked at your budgets for temporary staffing needs? Will it need to be expanded to ensure coverage?

- Have you done a cost-benefit analysis of not seeing patients vs. paying for temporary physicians?

- Have you discussed partnerships with local physician groups or the possibility of acquiring local practices to supplement your primary care needs?

- Is your organization allowed to hire foreign medical graduates practicing on J1 Visas?

Maximizing Efficiency

- Do you have a telemedicine program? How do you promote it with patients and physicians?

- Have you studied or attempted variable staffing models to maximize your efficiency during peak and non-peak hours?

- Are you using lean healthcare concepts and staff feedback to re-engineer your current processes to increase efficiency?

- How are you marketing to and educating prospective new patients to attract them to your organization and funnel them to the appropriate areas (a primary-care practice instead of the emergency room)? What are your competitors doing to attract these new patients?

Tips for Preparing for the PPACA

- Have an offer letter ready during physician recruiting visits to close the sale. Don't forget to market your organization and your community to the physician's family. Work with your board of directors to have compensation packages pre-approved.

- Compare your compensation packages with annual physician surveys to make sure your offers are competitive.

- Physicians and their families are likely to research your organization online. Monitor and be a part of the conversation to help build a great reputation that physician recruits will see.

- Develop creative incentive programs to attract physicians to your organization.

- Explore whether advanced practice professionals can help you offset a primary care shortage.

- Develop a plan to fight staff burnout before it happens to increase retention.

- Develop a community outreach plan to market your services to new patients.

- Leverage technology and use telemedicine programs to alleviate physician shortages.

- Go to your experts, your current staff, and engage them in identifying ways your organization can increase efficiency.

Know Your People's Demographic Differences

What's your first step in retaining your key people? Talk to them. Learn what their key issues and priorities are and know their hot buttons. Work with management to prioritize the issues. Develop goals that work for your organization in your effort to retain your employees. As illustrated in the table below from Deloitte[17], different demographic generations rank retention initiatives in different orders of preference. The physician level in the key Generation X and Baby Boomer groups score additional bonuses or financial incentives, additional benefits, and additional compensation as their top initiatives.

Understand Physicians' Financial Life Cycles

This next data point on the financial life cycle of physicians will be obvious to most readers; however, it bears repeating. Physicians begin their careers late (after substantial years in education and residency) burdened with substantial college debt. After a physician launches his career, he is at the age to begin a family, buy a home, and invest in his practice, adding more financial obligations to his college debt load. Rarely does he have an opportunity to begin saving for retirement, let alone early enough.

Top three most effective retention initiatives by generation: Executives vs. employees

Ranking	Millennials (31 and under)		Generation X (ages 32-47)		Baby Boomers (ages 48-65)	
	Executives	Employees	Executives	Employees	Executives	Employees
1	Company culture (21%)	Promotion/job advancement (41%)	Additional bonuses or financial incentives (21%)	Promotion/job advancement (64%)	Additional benefits (26%)	Promotion/job advancement (50%)
2	Flexible work arrangements (20%)	Additional compensation (40%)	Additional compensation (19%)	Additional bonuses or financial incentives (41%)	Additional bonuses or financial incentives (23%)	Support and recognition from supervisors or managers (43%)
3	New training programs or support and recognition from supervisors or managers (19% tie)	Additional bonuses or financial incentives (33%)	Strong leadership (19%)	Additional compensation (33%)	Additional compensation or strong leadership/ organizational support (21% tie)	Additional compensation (42%)

[17] Source: Deloitte whitepaper, *Talent Edge 2020*

It is critical to take into account the demographic situation of your physicians and key healthcare talent. Once done, you're in a position to address their needs with an appropriate plan approach. One aspect of a 360-degree plan is to zero in on benefits and retirement.

From an organization perspective, executive benefit plans and retirement savings vehicles are cost-effective strategies used by the Fortune 500 and leading organizations to attract, retain, reward and motivate top talent. Top talent and physician leaders drive high performance. High performing organizations enrich shareholders, create jobs, and grow the economy.

Now, let's move on to how to triage these issues and discuss some best practice solutions.

Best Practice Solutions for the Trendlines: Attract, Retain, Reward, and Motivate Healthcare Professionals

Executive Benefit Solutions advises leading organizations of all types and sizes on how to attract, retain, reward, and motivate key talent using well thought-out strategies such as nonqualified deferred compensation plans. Present and past clients include leading hospitals, physician groups, 200 of the Fortune 500, and a wide range of middle-market organizations.

We intend to share the details (both in this White Paper and in future ones) on how both tax-exempt healthcare providers and for-profit healthcare providers can gain an advantageous position in the demographic-driven war for talent by implementing well-designed executive benefit plans.

Executive Benefit Plans to Attract, Retain, Reward and Motivate Talent

Let's begin with a basic understanding of the gap in retirement income faced by high-income earners, such as physicians.

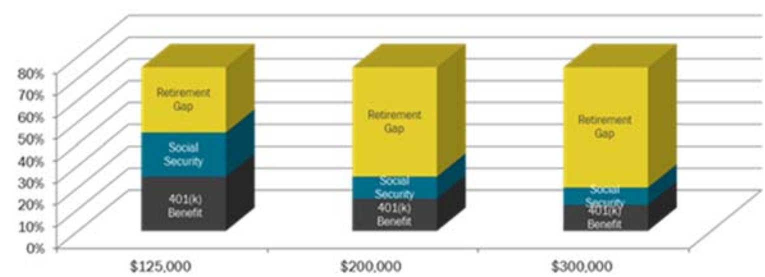
Nonprofit, tax-exempt organizations, and for-profits are limited in the types of benefit plans they are permitted to offer highly compensated employees. While qualified retirement plans like a 401(k), 403(b), 457(b) build a good foundation, they have their limits. See chart[18] below:

	Retirement Plan Contribution Limits		
Year	Plan	Age 49 & Below	Age 50 & Above
2015	401(k)	$18,000	$24,000
2015	403(b)	$18,000	$24,000
2015	457(b)	$18,000	$24,000
2016 (est)	401(k)	$18,500	$24,750
2016 (est)	403(b)	$18,500	$24,750
2016 (est)	457(b)	$18,500	$24,750

Executive Benefit Plans to Attract, Retain, Reward and Motivate Talent

Let’s begin with a basic understanding of the gap in retirement income faced by high-income earners, such as physicians.

As income levels of physicians increase, the gap in retirement income that must be filled by personal savings increases. The following table[19] will demonstrate this effect:



Assumptions:

- Age 45; retirement age 65
- 401(k) starting balance $50,000; contributions to max under laws
- Salary increases 4% social security; includes 3% annual cost of living adjustment
- 7% investment return

[18] Source: http://www.savingtoinvest.com/taking-advantage-of-new-401k/

[19] Source: Executive Benefit Solutions

Executive benefits should integrate into an organization's **total rewards program**. These benefits can be designed to drive the right behavior of the participants in the plan. Executive benefits and perquisites include deferred compensation, supplemental executive retirement plans, financial counseling, as well as supplemental life and disability insurance.

Overview of Executive Benefits

Executive benefits are often regarded as extra compensation; that is, payment over and above salary and bonus. Consequently, boards, stakeholders, and the media alike scrutinize executive benefit plans more than ever. Therefore, it is important to use an objective basis and process to determine which of the many possible benefits make good business sense.

It's equally important to know how these benefits can help or hurt an organization's ability to attract, retain, reward or motivate those key employees and physicians who make a difference in your organization.

The Dilemma

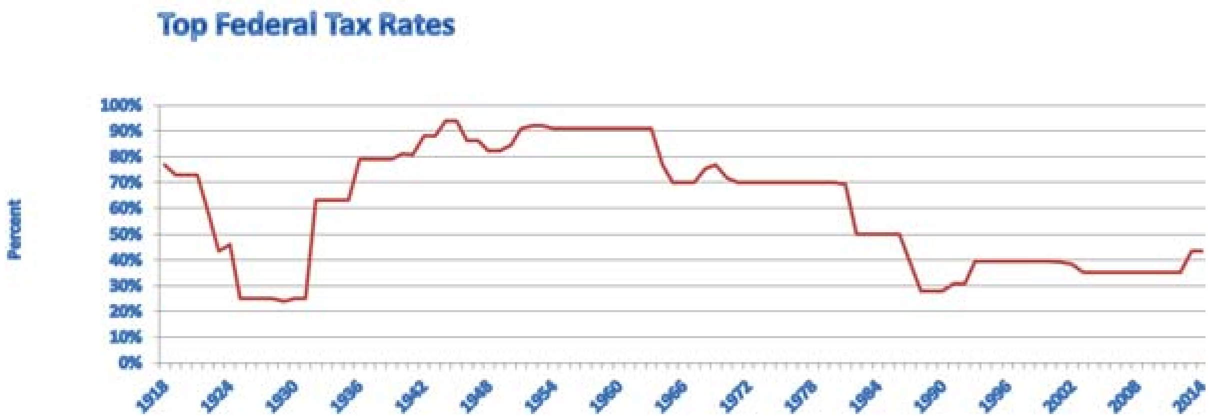
Risk of Tax-Rate Increase

Tax-deferred plans have lost some of their appeal due to the risk of future tax rates. If you think tax rates will rise, then why defer compensation today, only to receive it at a higher rate in the future? Today, most executives focus on distribution rather than accumulation because *"it's not how much you make, but how much you keep."* The distribution phase of your retirement planning (when you withdraw from the plan), could be the most important phase.

No one knows what income tax rates will be when they retire (see chart below[20]). Losing 35 percent due to taxes is a direct

[20] Source: http://bradfordtaxinstitute.com/Free_Resources/Federal-Income-Tax-Rates.aspx

and painful reduction in your retirement income. However, there are alternatives which can produce non-taxable income at retirement discussed in the text ahead.



Flexibility and Access to Deferrals

Most pre-tax deferral arrangements do not give the participant access to their account balances, unless they pre-elect a distribution feature subject to § 409A. Thankfully, there are alternatives that can give participants ready access to cash, a feature quite important to many.

Retention of Key Employees

One of the primary reasons for organizations to implement nonqualified plans is to provide incentive to retain employees. Retention programs can be developed around vesting or contributions to increase the odds a participant stays with the organization.

Cost-Neutral Plan

With further hikes in benefit cost, some organizations will not want to offer a benefit plan to key employees and contractors unless cost recovery can be measured and assured.

Plan Design Considerations

Inherently, nonqualified plans attract, retain, and reward highly compensated employees. However, structure and priority of design features hold the greatest potential to impact the organization and participant. In our opinion, the following inclusion of features and stated priority is key:

1. Tax-deferred savings for the participant
2. Flexibility and access to deferral while still employed
3. Avoidance of a "substantial risk of forfeiture"
4. Retention of key employee
5. Absence of any benefits subject to the claims of creditors of the organization
6. Provision of a cost-neutral plan for the organization

Let's now investigate select benefit solutions and how they work for both tax-paying and tax-exempt organizations.

Executive Benefit Plans for Tax-Paying Organizations

Deferred compensation forms the core of executive benefits. If designed optimally, it can be one of the lowest cost benefits that align the interest of executives with those of shareholders. The use of deferred compensation causes no dilution in ownership, nor does it cost the organization significant dollars to provide. In a deferred compensation arrangement, executives and physicians are offered the option of deferring their compensation into tax-advantaged accumulation accounts.

These accounts are comprised of the same compensation dollars that would have otherwise been paid in salary or bonus. Dollars are invested in mutual fund[21] investments, based on the

[21] ***Please consider the investment objectives, risks, charges, and expenses carefully before investing in Mutual Funds. The prospectus, which contains this and other information about the investment company, can be obtained directly from the Fund Company or your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.***

executive's risk tolerance. Today, many plans also offer annuity solutions and guarantees[22] to assure the income will be there when needed.

By example, the fund line-up the participant can defer all or a portion of his contributions into could include an option that generates life-time income, with guarantees in some contracts as high as five percent. Another option could allow participants access to index funds like the S&P 500[23], with a floor guarantee not to lose amounts deferred.

A typical nonqualified deferred compensation plan (NQDC) allows executives to defer 80 to 90 percent of their base salary and 100 percent of their annual incentive awards. The deferrals accumulate and grow at a set rate of interest or at a rate of return determined by some form of investment such as a mutual fund.

For many organizations, the primary objective of these programs is to offer an additional vehicle to facilitate wealth accumulation, as well as tax and portfolio management opportunities. NQDC plans today are more like a "tax-deferred cash management" program,

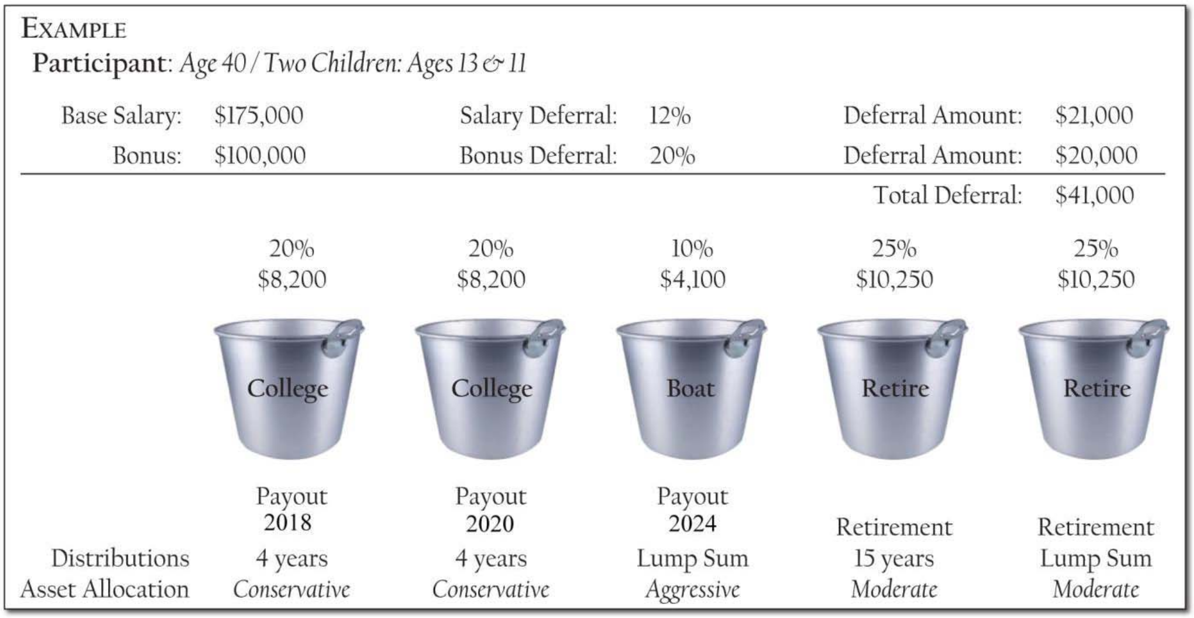
[22] Indexed annuities are insurance contracts that, depending on the contract, may offer a guaranteed annual interest rate and some participation growth, if any, of a stock market index. Such contracts have substantial variation in terms, costs of guarantees and features and may cap participation or returns in significant ways. Any guarantees offered are backed by the financial strength of the insurance company, not an outside entity. Investors are cautioned to carefully review an indexed annuity for its features, costs, risks, and how the variables are calculated.

[23] Indices are unmanaged and investors cannot invest directly in an index.

The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. It is a market value weighted index with each stock's weight in the index proportionate to its market value.

giving the executive an opportunity to plan for his or her life events, such as college tuition for their children or their retirement.

The following chart illustrates a 40-year old executive who elects to defer 12 percent of his $175,000 salary and 20 percent of his $100,000 bonus.



You will notice, he set up five "buckets" with various distribution dates. The first election is 2014, set up as a college fund for his son contributing 20 percent of his election, electing a distribution of four years beginning in 2018.

The second bucket was designed for his daughter who anticipates college in 2020. After the kids are out of school, he plans to buy a boat, so he elected to defer 10 percent of his contribution election until 2024. Each bucket also allows him to set up his asset allocation[24] based on the risk he is willing to take.

[24] Asset Allocation does not guarantee a profit or protect against a loss in a declining market. It is a method used to help manage investment risk.

And finally, he set up two retirement buckets: one designed for a lump sum payout, and the other to be distributed over 15 years. There are tax benefits when you take distributions over at least a 10-year period. The tax benefits allow you to retire in a lower tax state than the one in which you deferred the compensation; for example, deferring in California and retiring in Nevada where there are no state taxes.

Deferring Taxes

Many organizations also allow the participant to defer restricted stock units (RSUs), as a way of tax planning around these units when they vest. As an example, when an organization issues RSUs with a four-year vesting period, the executive pays taxes on the value at the time of vesting. In most cases, he or she sells off enough shares to pay the taxes. With an NQDC plan, the executive can elect to defer the RSUs within 30 days of issue, and own and control the shares within the NQDC plan, and not pay tax until he takes a distribution.

An NQDC plan is a valuable tool for management to align its interests with its shareholders. As cited earlier, an organization may decide to use such a plan to attract key employees, or let it serve as a parking place for signing bonuses with "golden handcuff" vesting requirements.

Finally, an organization may use such a plan as a retention tool offering an organization match that vests years in the future. The reason these plans are so prevalent is that the cost of offering such an arrangement is negligible due to the use of various funding vehicles. These plans provide executives with the advantage of tax-deferred savings and investment growth.

Executive Benefit Plans for Tax-Exempt Organizations

The structural differences between nonprofit and tax-exempt organizations, for example hospitals in the healthcare space, and their for-profit brethren are pronounced, especially in the design of NQDC plans for highly compensated employees.

Yet both for-profit and nonprofit entities face the same challenge in their efforts to attract, retain, and reward talented executives or professionals. How then does your organization spread the proverbial glue in the seat to prevent talent loss—a far more difficult effort for nonprofits which carry the added weight of IRS § 457 and § 409A requirements?

Executive benefits can help to counter the reverse discrimination of core benefit plans such as the 401(k), retirement, life, and disability, imposed on highly compensated executives by government limitations (see table on p. 14).

Nonqualified plans can deliver the right solutions if ERISA and § 409A requirements are met. But nonprofits and tax-exempt organizations must also meet the IRC § 457 requirements. If a deferral plan is designed to exceed the 457(b) limits, nonqualified benefits for executives and physicians must be subject to a "substantial risk of forfeiture."

Deferred Compensation Alternatives

Fortunately, alternatives are available. Nonprofit and tax-exempt organizations can address the needs of their highly compensated employees and contractors such as executives and physicians. By subjecting employer-paid, tax-deferred compensation to risk of forfeiture or by paying the required taxes, nonprofits and tax-exempt organizations can develop working alternatives for funding NQDC plans.

Depending on the objectives of the organization and the needs of the participant, nonprofit and tax-exempt organizations should consider the following alternative plan designs for offering nonqualified benefits. These plans can be designed separately or to work in concert with each other. Consider these two options:

- Split Dollar Plans
- Executive/Professional Bonus Plans

Note: Over the last several years, there have been dramatic changes in executive benefit plan design requirements for nonprofit and tax-exempt organizations. There are several new solutions we have worked on with clients, but are outside of the scope of this paper. We will discuss those solutions in a future paper.

Tax-Deferred Participant Savings

For a nonqualified plan to permit highly compensated participants to defer compensation in excess of § 457(b) contribution limits, IRS § 457(f) requires the benefits be subject to a "substantial risk of forfeiture."

For example, if an organization establishes a deferred compensation arrangement that provides an employee or physician with $50,000 per year for the ensuing two calendar years, the employee generally will be taxed on the $100,000 in the calendar year that the arrangement is established. This condition presumes that the $100,000 payment is not contingent on the employee performing substantial services for the organization in the two future calendar years.

If the participant "vests" in the benefits, then is he is no longer subject to a "substantial risk of forfeiture," and he will be taxed. That is why voluntary deferred compensation arrangements do not work well for nonprofit and tax-exempt organizations.

Deferred Compensation Alternatives

Depending on strategic objectives, your organization may want to consider one or both of the following alternative plans: Split Dollar or Executive/Professional Bonus. Let's examine these alternatives more closely.

Solution #1: Split-Dollar Arrangements[25]

A split-dollar plan is a versatile planning tool used by many nonprofit and tax-exempt organizations. Simply put, it is a funding arrangement that helps participants (employee or

[25] Split-Dollar Insurance is not an insurance policy; it is a method of paying for insurance coverage. A split-dollar plan is an arrangement between two parties that involves "splitting" the premium payments, cash values, ownership of the policy, and death benefits. These arrangements are subject to Split Dollar Final Regulations that apply for purposes of federal income, employment and gift taxes. Regulations provide that the tax treatment of split-dollar life insurance arrangements will be determined under one of two sets of rules, depending on who owns the policy.

contractor) obtain retirement income and death benefits at a cost lower than otherwise possible.

The organization pays premiums on a life insurance policy owned by the participant, but retains a collateral-assignment interest in the policy equal to the sum of the premiums (their contributions) it has advanced (loaned). Premium advances are treated by the IRS as a loan and the participant pays taxes annually on the imputed loan interest based on the applicable federal rates.

These arrangements are designed to provide participants with death benefit protection and also to provide a source of retirement income (from the cash value build up in the policy). These plans work well in these circumstances:

- Organization wants to provide a death benefit, as well as supplemental retirement plan to its highly compensated employees and/or contractors, and;
- Organization wants to recover its cost with a cost-neutral benefit plan.

IRS Notice 2007-34 requires split-dollar arrangements to be in writing and conform to § 409A.

At retirement, the participant vests in the full cash value of the split-dollar life insurance policy and can use that cash to supplement income. Many of these arrangements use variable universal life insurance to provide cash build up similar to the taxable investments in a 403(b) plan. The key is to secure a high cash-value policy that is institutionally priced. In this way, the participant can realize 100 percent cash value in year one, with no surrender charges.

For more information, see the EBS study at:
http://www.executivebenefitsolutions.com/resource/split-dollar-research-report

Solution #2: Executive/Professional Bonus Plans

Under this strategy, the organization selects either a cash value life insurance policy or a mutual fund account for participants, using after-tax dollars it contributes. Then, the organization makes a contribution to the account, which is owned and controlled by the participant. The account is treated the same as a bonus to the participant for tax purposes.

Although the participant is taxed on the bonus, the funds are directed to the life insurance policy or mutual fund account under his control. From a tax standpoint, most participants prefer the life insurance policy because the cash value, which is normally a family of taxable investments, grows taxed deferred and they can access income at retirement on a non-taxable basis. The participant usually pays lower insurance costs versus taxes when the two alternatives are compared, as illustrated in the chart below:

	Taxable Investments	Executive/Professional Bonus Plan	
		Year One	Life of Plan
Gross Return	7.50%	7.50%	7.50%
Investment Fees	0.50	0.50	0.50
Net Return	7.00	7.00	7.00
Taxes @ 40%	2.80	-	-
Insurance Fees	-	1.10	0.37
After-Tax Yield	4.20%	5.90%	6.63%
Impact of Taxes / Insurance Loads	40%	16%	5%
(% Of Net Return)			

Note: The above examples are hypothetical and for illustration purposes only.

By applying these funds to purchase a life insurance policy–again, under the participant's ownership and control, he earns income tax-free cash value build-up, accessible via withdrawals and loans for supplemental retirement income in later years. This arrangement offers solid flexibility since it is not subject to §409A restrictions. Importantly, the Executive/Professional Bonus Plan offers the participant both a death benefit and non-taxable income through policy withdrawals.

As in split-dollar, it is important to use an institutionally priced insurance contact with Executive/Professional Bonus Plans, with the potential for 100 percent cash value in year one and no surrender charges. These contracts are normally only used by major corporations to fund deferred compensation plans but, on a limited basis, could be offered to your nonprofit or tax-exempt organization. Funding product evaluation is important.

These arrangements work well under these circumstances:

- Participant wants flexibility and control of asset outside the reach of the organization's creditors;
- Participant believes that tax rates will increase in the future;
- Organization wants a simple arrangement;
- Organization and participant want a tax-deferred device not subject to restrictions under section 457(f) and 409A.

From a retention standpoint, many organizations use a "restricted bonus arrangement" to tie the participant closer to the organization. It requires the participant to reimburse some or all of the organization's contributions if he departs within a specified time. Primarily, these arrangements are funded with life insurance. However, they can work with taxable investments as well. A restrictive endorsement can be placed on the poly to limit the participant's ability to access the cash value without the consent of the organization.

The restrictive bonus arrangement works well under these circumstances:

- Organizations wants to provide retention of its highly compensated employees or independent contractors;
- Participant wants flexibility and control of the asset;
- Organization wants a simple arrangement;
- Organization and participant want a plan not subject to the limits or restrictions of §457(f) and 409A.

Executive Benefit Plans For <u>Both</u> Tax-Paying and Tax-Exempt Organizations

Excess Benefit Plans

There are two types of excess benefit plans available, but both restore lost qualified retirement benefits due to legislative limits. Excess benefit plans, like a deferred compensation plan, are nonqualified. They are exempt from the filing, reporting, funding, and fiduciary requirements of ERISA (Employee Retirement Income Security Act).

The first type of excess benefit plan restores benefits due to §415 limits. We refer to this plan as a restoration plan and it simply compensates for lost qualified plan benefits. For 2015, the defined benefit plan limit is $210,000 (§415(b)) and the defined contribution plan limit is $53,000 (§415(c)).

These plans can be in either a defined benefit form, as a supplement to a qualified pension plan, or in a defined contribution form that may, for example, restore benefit contributions in a profit sharing or 401(k) plan. The second type of plan restores benefits withheld due to compensation limits (§401(a)(17)).

§401(a)(17) is imposed on qualified defined benefit and defined contribution plans. In 2015, the compensation limit under this section was $265,000. This provision could significantly lessen executives' qualified plan payments, particularly those of the top echelon of executives who often earn well in excess of these limits.

Supplemental Executive Retirement Plans (SERPs)

SERPs are nonqualified plans that do more than restore excess pension plan benefits. These plans can provide additional benefits by applying a different definition of compensation that might, for example, include annual incentives or other compensation. Further, they can offer more advantageous provisions than those offered by qualified plans. Some of the typical feature enhancements include an alternative benefits formula, different accrual pattern, or different early retirement.

A SERP can be very flexible in design. It can take on the form of either a defined contribution or defined benefit plan. In addition to the objectives of retirement income security and wealth accumulation, SERPs are often designed to achieve other objectives such as providing an attractive recruitment tool for mid-career executives, rewarding for performance by linking to organization performance goals, and being used as a retention tool.

SERPS are often considered the most effective type of supplemental retirement program because of their inherent flexibility. The prevalence of “performance- based SERPs” has increased as they have proven more cost-effective than stock options or restricted stock with no dilution.

An organization can zero in on the type of performance it requires; that is, increased margins, cash flow, net earnings, EBITDA (earnings before interest, taxes, depreciation and amortization), or earnings per share.

Securing the Benefit

With new secular trust and insurance after-tax funding designs, these arrangements can be structured as tax deductible to the organization and fully secured against organization creditors. A secular trust is an irrevocable trust, usually established by the employer that holds assets for the exclusive purpose of providing funds for the payment of nonqualified benefits.

The establishment of a secular trust provides additional security to participants over and above the rabbi trust in that the assets in a secular trust are not subject to the claims of the organization’s creditors.

Today, the secular trust concept can be achieved by using institutionally priced life insurance contracts owned by the executives. Using life insurance policies allows for the accumulation of cash value on a tax-deferred basis, and distributions that are non-taxable, which could provide greater amounts of retirement income than traditional deferred compensation plans that are taxed at distribution. The portability of these plans is a key attraction to executives, too. The implementation of this concept is growing faster than traditional deferred compensation arrangements.

Supplemental Life Insurance

In connection with sound financial and estate planning, life insurance programs that provide income replacement are not uncommon at executive levels. Most basic group plans offer limited opportunity to provide significant levels of death benefit protection.

The disconnect between an organization's life insurance policy and its total compensation and benefits strategy occurs when the bulk of an employee's compensation is derived from bonus and incentive pay while the group life plan delivers a benefit based on a multiple of salary (1.5 times the salary with a cap of $200,000).

As a result, organizations that offer a total compensation package that emphasizes security and flexibility should consider providing supplemental life insurance protection as a multiple of total compensation for its top management. The rule of thumb is three to five times the total pay with no cap.

Executive Long-Term Disability

Similar to group life insurance, group disability plans have limitations and often exclude total compensation. The group disability plans also offer a multiple of salary with some monthly cap - 66.67 percent of salary with a cap of $15,000 – which results in a large income gap for highly compensated employees and physicians. Today, organizations are designing supplemental plans to fill the void.

Perquisites

Perks come in many shapes and sizes: access to corporate aircraft, country club dues, car allowances, gym memberships and more. One of the fastest growing perks is financial counseling because it ties everything together.

With the ever-increasing complexities surrounding financial planning and the myriad of investments now commonly used by even average salaried employees, financial counseling and planning services are prized by executives.

In our long experience, perceived value exists. There is measurable value in financial counseling services that motivates executives and professionals to focus their full attention on organizational performance, secure in the knowledge that their personal finances are kept in order. Financial counseling and planning can also substantially enhance an executive's appreciation and understanding of the value of the total compensation package as offered through organization-sponsored benefit programs.

Net Takeaway

Now that you are armed with useful information, you are ready to determine which executive benefits fit within the total compensation package. You may also benefit from the expertise of a professional services firm in this determination.

Here are the basic steps in the process:

1. **Determine Objectives**
   - Design a program to correspond with the total compensation philosophy of the organization.

2. **Examine Benefit Security Devices.**
   - In general, executive benefits are nonqualified so to maintain perceived value, you must secure the benefit with a Rabbi Trust. You must also analyze the cash flow and profit and loss impact to guarantee your benefit plan is resilient and cost-effective for shareholders.

3. **Obtain the Board of Directors Approval**
   - Be sure to incorporate formally the program, its purpose, objective, eligibility, structure, and administration/monitoring requirements in the total compensation and benefits strategy.

4. **Implement the Plan**
   - The best-made plans may be ignored or undervalued if the benefits are not communicated properly and frequently. Implementation represents the heart of your plan, and

communication its blood flow. Many firms use branded web-based portals, online enrollment, financial counseling, and other dedicated content to communicate the plan.

5. **Select Appropriate Vendors and Administrators**
   - These service providers can ensure performance tracking, cost management, and program communications, to name a few of their valuable services. Consider first the existing vendor to your 401(k) plans. In this way, it can coordinate executive benefits with existing programs to offer a more seamless benefit statement, which will be welcomed by your participants.

6. **Monitor the Plan**
   - Given the complexities of compensation benefits, taxes, and legislative changes, it is advisable to work with an effective outside specialty firm that will take a comprehensive approach to your situation, pinpoint what you've overlooked, and pay handsome dividends over the long run in terms of peace of mind.

Next Steps

The essential first step is to take inventory of what your organization offers to what level of employee, whether physician, frontline or mid-level employee. Consider offering organization-sponsored financial counseling, which will help potential participants better understand what their true needs are across the three primary risks discussed above.

When you retain, reward and motivate organizational leadership and employees, you drive higher performance. High-performing organizations enrich shareholders, create jobs, and grow the economy, a win-win for everyone involved.

In the uncertain years ahead, organizations will need every talented employee possible to fill the growing management void, and that demands a powerful benefits magnet to attract, retain, and reward them.

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For more information on how you can attract, retain and reward healthcare talent, please contact one of our advisors:

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