Why Non-Profits Are So Interested in Split-Dollar Life Insurance

Should you be, too?

An Educational White Paper for Non-Profit Organizations
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Not a week goes by without discussion of "split-dollar life insurance" in non-profit organizations. Donors, alumni, and friends of the organization want to learn about the topic. Even media outlets from ABC News to ESPN have joined the financial planning community to explore split-dollar as a compensation solution for non-profits.

What has piqued the interest of so many? Essentially, two recent developments:

1. The University of Michigan (U-M) head football coach Jim Harbaugh's compensation arrangement included split-dollar life insurance;
2. The new 21 percent excise tax applicable to "excessive compensation" paid by a tax-exempt organization under the 2017 Tax Cuts and Jobs Act.

Even though tax-exempt organizations have long dealt with the onerous tax restrictions under Section 457(f), and they understand how to use split-dollar life insurance to plan around those restrictions, the 2017 Tax Act sparked renewed interest. Now, the potential exists to use split-dollar to mitigate the looming significant additional expense of the new 21 percent excise tax.

Gain Perspective

To more clearly understand the benefits of using split-dollar life insurance arrangements as an executive compensation planning tool in the non-profit environment, we need to step back. Let's review the tax treatment and Form 990 disclosure requirements of nonqualified deferred compensation (NQDC) programs sponsored by non-profit organizations; and then on a comparative basis, consider the economics, taxation, and disclosure requirements for split-dollar arrangements.

Current Tax Law for Non-Profit NQDC Programs

NQDC plans sponsored by non-profit organizations may be subject to taxation under both Section 409A and Section 457(f). Section 409A (applicable to virtually all forms of NQDC plans) was added to the Internal Revenue Code in 2005 in response to certain perceived abuses of NQDC plans during some of the corporate scandals of the early 2000s, imposing new restrictions on the deferral of compensation and the distribution options under such plans.

In 1986, the IRS introduced Section 457(f) (applicable to "ineligible" NQDC plans sponsored by tax-exempt organizations). In 2007, after the enactment of Section 409A, the IRS published a notice regarding its intent to coordinate the provisions of Section 409A and Section 457(f); and, after only nine years, issued proposed Section 457(f) regulations in 2016 to provide some welcomed guidance.

To defer taxation under Section 457(f), a participant must be at a substantive risk of forfeiture. As soon as that risk lapses (typically upon vesting), the deferred compensation is taxable. In general, a benefit is subject to a substantial risk of forfeiture if it is, "conditioned upon the future performance of substantial services." Because of this limitation, traditional deferred compensation arrangements don't provide the planning flexibility in the non-profit environment that they do in the for-profit world.

Congress' rationale for adding yet another requirement for NQDC plans of tax-exempt organizations is the lack of "tax tension" between non-profits and for-profit corporations over the taxation to the employee and tax deduction for the employer.

Competitive Disadvantage

Non-profit organizations actively compete with for-profit corporations for management and professional talent. Thus, this additional tax restriction, combined with the inability to offer equity-based programs, creates a significant competitive disadvantage.

The Proposed Section 457(f) Regulations released in 2016 provide guidance and, contrary to expectations, limited planning opportunities. For example, in certain situations, it may be possible to allow for the voluntary deferral of compensation, an extension of the period of risk of forfeiture, or the use a non-compete agreement to establish the required risk of forfeiture. However, these planning options have very limited applicability.

Corporate America Windfall vs. Challenged Non-Profits

Let's spend a moment on the second factor cited above for the renewed interest in split-dollar life insurance arrangements—the new 21 percent excise tax under the 2017 Tax Cuts and Jobs Act.

Conceptually, the new excise tax under Section 4960 is designed to provide symmetry with the disallowance of a deduction for compensation more than $1 million for publicly-traded corporations under Section 162(m). Since the loss of a deduction doesn't matter to a tax-exempt entity, Congress decided to impose a 21 percent excise tax on "excessive compensation."

Which Employees are Covered Under the New Excise Tax?

The definition of a "covered employee" under Section 4960 includes more than officers. It includes *any* current or *former* employee who is (or was) among the five highest paid in a tax year beginning after December 31, 2016. Once an individual is classified as a "covered employee," he/she will always be considered a "covered employee." *That means the excise tax could be triggered by deferred compensation payments to a former executive after retirement.*

What is "Excessive Compensation?"

Compensation is deemed to be excessive if it exceeds $1 million in any tax year, or if it meets the definition of an "excess parachute payment." Generally, all wages reported on an employee's W-2 are taken into consideration, including:

- Deferred compensation when taxable upon vesting under a Section 457(f) plan (regardless of when paid),

- Distributions paid from a non-governmental Section 457(b) plan or,
- Compensation paid by a related or supported organization, such as a hospital and a surgical center or nursing home.

Under a "surgeons' exception," compensation paid to a licensed medical professional for medical services is excluded. *However, amounts paid to a licensed medical professional for executive/administration duties are included.*

<u>What is an "Excess Parachute Payment?"</u>

First, a "parachute payment" is any compensation that is contingent upon the separation from service of an employee, including; severance pay, deferred compensation that vests upon termination, and/or the continuation of health care benefits. However, qualified retirement plan benefits, distributions from a governmental Section 457(b) plan, and payments to a licensed medical professional related to medical services are excluded.

The definition of an "excess parachute payment" is based on a simple mathematical test which compares the present value of all benefits triggered by a separation from service to an amount equal to three times the employee's average annual compensation for the five years preceding termination. For example:

- If the present value of deferred compensation and continuing health care coverage triggered by a separation from service is $900,000 and,
- The employees' average annual compensation for the five years preceding retirement was $200,000,
- The benefits would represent an "excess parachute payment" (as $900,000 exceeds three times $200,000),
- And, the organization would be subject to excise tax in the amount of $147,000 (($900,000 - $200,000) x 21%).

Note: As illustrated in this example, the excise tax applies to an "excess parachute payment," even if less than $1.0 million.

<u>When Does the New Excise Tax Apply, and are There Grandfathering Rules?</u>

The excise tax under Section 4960 applies for tax years beginning after December 31, 2017; and, there is no transition rule or grandfathering of existing agreements.

For example, it would apply to deferred compensation benefits under a Section 457(f) plan when vested in 2018, regardless of the date of the agreement.

Split-Dollar as an Executive Benefit: The Basic Concept

The concept is simple and straightforward. First, split-dollar life insurance isn't a form of life insurance product, like term life insurance, whole life or universal life insurance; it is a form of ownership of cash value life insurance.

Split-dollar is a strategy that allows the sharing of the cost and benefits of a permanent life insurance policy. Any type of permanent life insurance policy that builds a cash value can be used; however, the type of policy and structure is very important and should be tailored to the objectives of the organization and the needs of the executive/professional (i.e., retirement income, death benefits, etc.).

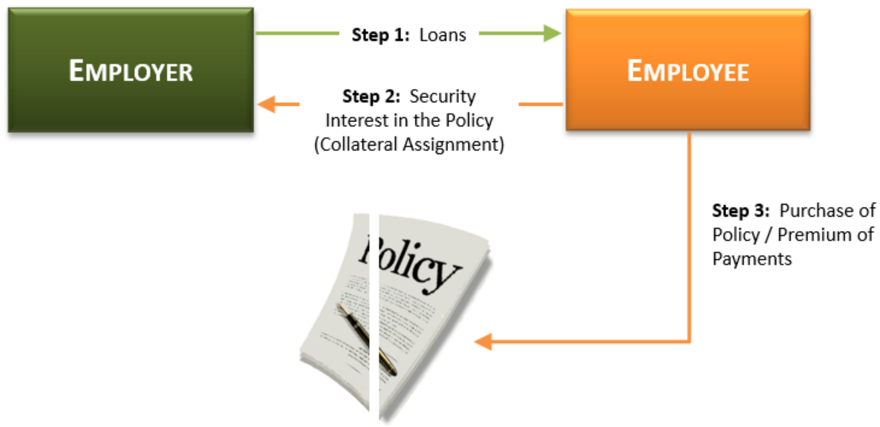
Split-dollar brings together the life insurance and supplemental savings needs of an employee with the premium paying ability of the employer. It appeals to both employers and employees: the employee gets the life insurance protection he/she needs at an affordable cost and supplemental tax-advantaged savings in the form of cash value accumulation. The employer can custom design a program for selected key employees/professionals and provide a valuable benefit on a cost-effective basis. Historically, what has made split-dollar attractive is the opportunity for both tax leverage and interest rate arbitrage.

Graphic Illustration of Concept

The following graphic illustrates two aspects of the basic concept of a Loan Regime Split-Dollar arrangement:

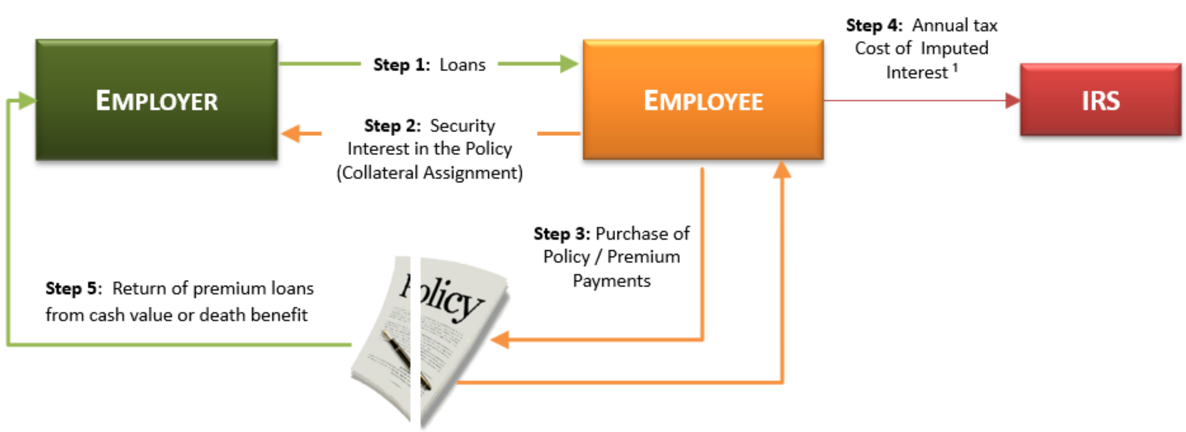
- The mechanics and the split of policy rights between employer and employee/participant
- The economics and taxation

Loan Regime Split-Dollar: *Mechanics and Contract Rights*



Policy Rights	
Employer:	***Employee:***
• *To recover premium loans from policy cash value or death benefit* • *Secured by Collateral Assignment*	• *Owner of policy, subject to rights assigned to Employer* • *Cash value and death benefit in Excess of Employer's Interest*

Loan Regime Split-Dollar: *Economics and Taxation*



Cost / Benefit	
Employer:	***Employee:***
• *Opportunity cost of money on premium loans* • *Conversion of compensation expense to an asset* • *Favorable Form 990 treatment*	• *Non-Taxable Supplemental Retirement Income* • *Significant Life Insurance Coverage* • *At Minimal Cost*

1 - Alternatively, the plan could be structured to require the Employee to pay interest on the Employer Loans and the Employer could Bonus a "grossed-up" payment to the Employee to reduce his/her cost to zero.

Tax Law Applicable to Split-Dollar Arrangements

The history of tax law applicable to split-dollar arrangements stretches back to the 1960s; however, it has been significantly modified and refined in the last 15 years. In 2003, the IRS issued comprehensive split-dollar regulations which clarified the tax treatment of arrangements commonly in use at that time.

In 2005 when the IRS enacted Section 409A, the primary focus centered on deferred compensation programs. However, it also has applicability to a split-dollar arrangement that includes an element of deferred compensation.

Under current tax law, there are two basic forms of split-dollar, generally differentiated by the ownership of the underlying policy, "Economic Benefit" split-dollar and "Loan Regime/Collateral Assignment" split-dollar arrangements. In the context of compensation and benefits planning for non-profit organizations, the most commonly-used structure is the Loan Regime/Collateral Assignment Split-dollar Plan.

Loan Regime/Collateral Assignment Split-dollar

In this case, the underlying policy is owned by the executive/professional and the organization advances all (or virtually all) of the premium payments. The employer retains a security interest in policy values in the form of a collateral assignment, which is released at the time of repayment (typically, at termination of service or at death). The employee either pays the interest on the loans, or is taxed on the "imputed" interest based on the Applicable Federal Rate (AFR) in effect. In some cases, the employer may forgive repayment of the loans, which would trigger taxable income to the employee in the form of "forgiveness of indebtedness" income.

- A critical factor in the success of these arrangements is the way the loans are structured, which determines the chargeable interest rate. The premium advances can be structured as either a demand loan or as a term loan. In the case of a demand loan, the appropriate interest rate to be used is based on an annual blended rate published by the IRS - the Applicable Federal Rate (AFR). In the case of a term loan, the appropriate AFR is determined based on the term of the loan (short-term, mid-term or long-term) and the AFR as of the month in which the loan is made.

- It is important to work with a knowledgeable consultant through the process of determining the loan structure that provides the greatest potential benefit, with the least exposure to interest rate fluctuations, on a tax-compliant basis.

A Split-Dollar Arrangement for a Key Employee: A High-Profile Example

In the case of the University of Michigan (U-M)/Harbaugh split-dollar arrangement, the structure (as described in the U-M Form 990) is generally as follows:

- Beginning in 2016, U-M pays six annual life insurance premiums of $2 million. Although the death benefit is unknown, it is estimated to be as high as $75 million, based on Harbaugh's age and relative health.
- Harbaugh owns the policy subject to a collateral assignment [2] in favor of U-M.

- Essentially, U-M is providing Harbaugh with an interest-free loan of the annual life insurance premiums.
- Each year (assuming Harbaugh does not pay interest on the loan), he must include an "imputed" interest charge in taxable income based on the Applicable Federal Rate (AFR).
- If Harbaugh dies while the agreement is in force, U-M would be repaid the premium advances from its share of the policy death benefit, and Harbaugh's beneficiary receives the remainder.
- If Harbaugh quits, is fired, or leaves, U-M would be repaid through a withdrawal of policy cash value. After repayment of the premium advances, U-M would release its security interest in the policy and Harbaugh would own the policy outright, including any remaining cash value. This payback provision motivates Harbaugh to stay with U-M.
- Harbaugh can borrow from the policy's cash value at any time if the policy still meets sustainability requirements.
- After the six-year period, the agreement may end at which time U-M would be reimbursed for the premiums advanced from the policy cash value. However, the plan allows for amendments or modifications; for example, if the parties choose to extend the agreement beyond six years. This feature is one of the flexible aspects of a split-dollar agreement.
- The cost to U-M is the opportunity cost of money on the premiums advanced. Harbaugh's cost is the tax cost of the annual imputed interest charge (a modest amount as compared to the premiums).

*(2) As discussed later, when a **collateral assignment split-dollar** arrangement is used in a business context the employee (or an irrevocable life insurance trust established by the employee) typically owns the policy. The employer advances the policy premiums and retains a security interest in policy values (cash value and death benefit) to protect its right to be repaid.*

The bottom line? The split-dollar plan appeals to both U-M and Coach Harbaugh. He receives the life insurance protection he needs at an affordable cost and a source of potential tax-free supplemental retirement income. What's more, U-M can provide a valuable benefit to a key employee at relatively little expense.

Although the Harbaugh case involves a college football coach for a public university, the split-dollar concept is also commonly used for key employees and professionals of all forms of non-profit organizations, including medical centers, research institutions, private foundations, and others.

Comparison of 457(f) Plans to Split-dollar Plans

The matrix below provides a comparison of the key characteristics of a commonly used Section 457(f) defined contribution Supplemental Executive Retirement Plan (SERP) to a loan regime split-dollar arrangement.

COMPARISON OF KEY CHARACTERISTICS
Section 457(f) DC SERP vs. Loan Regime Split-Dollar

Key Characteristic	Section 457 (f) Defined Contribution SERP	Loan Regime Split-Dollar Arrangement
• *Nature of participant benefit*	• *Lump-sum payment of account balance upon vesting*	• *Potentially tax-fee supplemental retirement income, if contract properly structured* • *With flexibility on timing and amount of withdrawals* • *Permanent life insurance coverage*
• *Taxation of benefits to participant*	• *Benefit taxable to participant at ordinary income tax rates upon lapse of "Substantial Risk of Forfeiture," regardless of when paid*	• *Annual taxable imputed interest on premium loans at the AFR* • *No taxation at the time of termination of the S/D arrangement, as there is no transfer of an asset* • *Potentially tax-free supplemental retirement income (if contract properly structured), the timing of which is controllable by the Participant*
• *Ownership of funding assets*	• *Sponsoring organization (if Plan informally funded)*	• *Participant owns the underlying life insurance contract*
• *Risks to participant*	• *Risk of forfeiture (if participant voluntarily terminates employment before the specified vesting period)* • *Investment risk (if Plan offers notional investment choice)* • *Credit risk: Participant is an unsecured general creditor of the sponsoring organization*	• *Investment/policy performance risk (the risk that the policy cash value will not grow as fast as expected)* • *Interest rate risk (the higher the AFR, the greater the tax cost)*
• *Investment flexibility*	• *Plan designs vary. Possible to offer notional investment choice to the participant*	• *Allocation of policy cash value among investment options, including equity indexes with downside protection*
• *Life insurance benefit*	• *No*	• *Yes. However, loads and expenses of insurance contract impact investment returns, if coverage not needed*

COMPARISON OF KEY CHARACTERISTICS CONTINUED
Section 457(f) DC SERP vs. Loan Regime Split-Dollar

Key Characteristic	Section 457 (f) Defined Contribution SERP	Loan Regime Split-Dollar Arrangement
• *Retention characteristics*	• *Strong, as a participant is at risk of forfeiture of entire benefit any time before the vesting date*	• *No risk of forfeiture, but the value of the participant's benefit grows over time and may not be of significant value for several years*
• *Financial impact to sponsoring organization*	• *Compensation expense accrued annually* • *Balance sheet liability equal to aggregate account balances*	• *Compensation expense converted to a balance sheet asset – loans to participants* • *Opportunity cost of money on premium loans*
• *Exposure to new Section 4960 21% excise tax*	• *Yes, if benefits at the time of vesting are more than $1 million* • *Or if the benefit represents an "excess parachute payment"*	• *Loans to participant not subject to the excise tax*
• *Form 990 disclosure*	• *General description of the plan* • *Disclosure of compensation expense in Schedule J when benefit accrued, and again when paid*	• *Disclosure of loans to interested persons on Schedule L (balance sheet section)* • *Annual imputed interest reported as compensation in Schedule J*
• *Other issues*	• ***Limited*** *planning opportunities under the 2016 Proposed 457(f) Regs:* - *Non-compete agreement* - *Consulting agreement* - *Severance plan* - *Voluntary deferral of comp.* - *Extension of forfeiture period*	• *Proper structuring and management of policy loans critical to cost-effectiveness and tax compliance* • *Varying effectiveness for participants at different ages* • *Prohibition of loans to Executive Officers in certain states*

Your Takeaway Message

Referring back to our original question: Why all the renewed interest in split-dollar arrangements?

1. ***<u>The comparative tax advantages of a life insurance-based program</u>*****:** Section 457(f) programs trigger income taxation to the participant on the value of the entire benefit when vested, regardless of when the benefits are paid. As a result, virtually all Section 457(f) plan benefits are paid in the form of a lump-sum upon vesting. A split-dollar program can be designed to provide non-taxable supplemental income timed to meet the participant's needs (if the contract is properly structured and administered).

2. ***<u>The avoidance of the Section 457(f) requirement for "substantial risk of forfeiture</u>*****:"** Under a loan-regime split-dollar arrangement, the sponsoring organization (rather than the IRS) can design the vesting and forfeiture provisions to meet the organization's retention objectives in a manner responsive to the participant's needs.

3. ***<u>The reduced exposure to the new Section 4960 21% excise tax</u>*****:** A Section 457(f) plan can trigger the excise tax if the value of the participant's benefit upon vesting is more than $1 million, or if the benefit represents an "excess parachute payment" (even if less than $1 million). Loans made to participants under a split-dollar arrangement are not subject to the excise tax.

4. ***<u>Greater benefit security</u>*****:** Under a loan regime split-dollar arrangement, the participant owns the underlying life insurance contract from day one, with an assignment to the sponsoring organization of an interest in policy values related to the premium loans until the loans are repaid. In the case of a Section 457(f) plan, the Participant's rights to benefits are exposed to the claims of the sponsoring organization's creditors in the event of bankruptcy or insolvency.

5. ***<u>The relatively favorable Form 990 disclosures</u>*****:** Compensation expense related to a Section 457(f) plan is disclosed in Schedule J twice; at the time the benefits are accrued, and again upon payment. Under a loan regime split-dollar arrangement, the sponsoring organization's contributions are converted from an expense to an asset, reported as a loan on Schedule L. Only the relatively modest annual imputed interest to the executive is reported as compensation expense on Schedule J.

As always, pros and cons pertain to each plan structure, and the applicability of either depends on the objectives of the sponsoring organization and the needs of its participants. In our practice, we find a combination of plans is often the most effective for our clients

Recommended Next Steps

Non-profit organizations should reconsider the design and cost-effectiveness of the supplemental compensation and benefits programs they sponsor. Specifically:

Identify exposure to the new Section 4960 21% excise tax:

- Identify "covered employees" and create a mechanism for future identification and tracking.

- Review existing employment agreements, incentive plans, supplemental savings and retirement programs and severance plans to identify possible applicability.

Create a comprehensive financial model:

- To provide a comparison of the after-tax value of benefits delivered to participants to the cost to the organization with and without the excise tax using a variables-driven model to consider a range of assumptions or plan design options.

Consider modification of existing programs to reduce exposure to the excise tax, or to improve cost-effectiveness. For example:

- Re-structuring of vesting provisions:
  - Longer, or rolling vesting periods to spread payments over multiple years
  - Vesting based on age rather than separation from service to avoid the "excess parachute payment" provisions

- Shifting between base pay and deferred compensation, split-dollar arrangements and/or severance benefits.

- Incorporating some of the planning opportunities under the 2016 Proposed Section 457(f) Regulations:
  - Short-term deferral exception
  - Post-termination non-compete agreement (with real substance)
  - Consulting contract
  - Voluntary deferral of compensation (with a significant retention bonus)
  - Extension of the period of risk of forfeiture (with a significant retention bonus)

N.B: *It is important to remember that existing Section 457(f) programs are not* ***grandfathered. The excise tax could be triggered at the time of vesting in the future.***

Consider the design of programs to be used in the future. For example:

The use of a loan regime split-dollar arrangement in combination with a mid-term incentive plan in the form of a Performance-Based Defined Contribution SERP. In the case of a non-profit health care organization:

- Design the DC SERP with performance-based annual contributions tied to achievement of goals in the transition from pay-for-service to pay- for-outcomes:

- Quality of care initiatives
- Reduction in readmissions
- Cost containment measures
- Vesting could be on a rolling 3 or 5-year basis

▪ The loan regime split-dollar arrangement would be designed to provide long-term tax-advantaged savings and a significant life insurance benefit.

▪ From the sponsoring organization's perspective, the combined program represents an effective incentive compensation plan focused on specific strategic and financial goals.

▪ From the participant's point of view, the combined program offers a valuable, tax-advantaged savings and life insurance benefit.

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We began this paper with a timely question on why non-profits are expressing so much interest in split-dollar life insurance. Next, we reviewed how current tax law, exacerbated by inherent restrictions on non-profits, places non-profits at a serious competitive disadvantage.

Then, we introduced the loan-regime concept for split-dollar, pointing out its many advantages in tax treatment compared to commonly used Section 457 (f) DC SERPs.

Finally, **we urged non-profit organizations to revisit and reconsider the financial effectiveness of their current supplemental compensation and benefits programs** due to exposure to the excise tax, and the promising outcome of the University of Michigan example with Coach Harbaugh.

The managing directors of Executive Benefit Solutions invite you for a brief courtesy conversation to further simplify the complexities of the loan-regime concept for split dollar and to determine if it is appropriate for your organization.

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Split Dollar Disclosures:

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.

The Sarbanes-Oxley Act of 2002 makes it unlawful for a company regulated by the Securities Exchange Act of 1934 ("34 Act") to directly or indirectly make loans to its directors or executive officers. This includes not only companies required to register their securities under the 34 Act, but also companies required to file reports (i.e. 10k and 10Qs) under the 34 Act. Please consult with your attorney before purchasing a life insurance policy that will be corporate/business owned or used in a split dollar arrangement to determine what restrictions may apply. This information is not intended to be tax advice. Please consult your tax advisor for more information regarding the tax implications of this policy.

About Executive Benefit Solutions

EBS is an independent consulting firm with a single focus: working with clients to improve the cost-effectiveness of compensation and benefits programs for key employees and professionals.
Services include:

- *Custom plan design, supported by comprehensive financial analysis*
- *Structuring of related financing and benefit security arrangements*
- *Providing education and technical support for participants*
- *High-touch plan administration and financial reporting and analysis*

Our approach is highly analytical, collaborative and characterized by clear and open communications with the plan sponsor and participants.

For more information, please visit our website at: ***www.executivebenefitsolutions.com***.