Advanced Markets Blog

Executive benefit planning with split dollar for tax-exempt organizations

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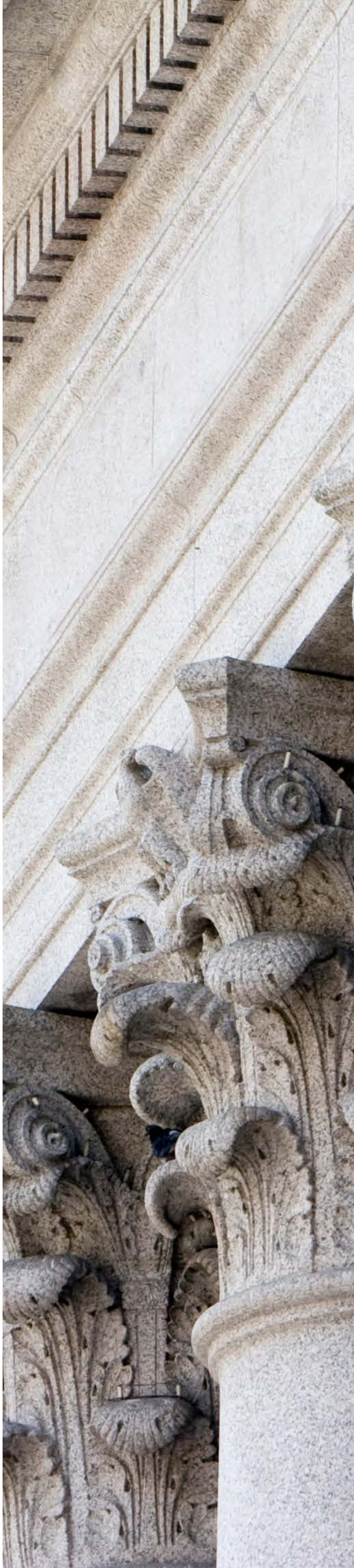
Split dollar has long been a popular planning technique for businesses — including tax-exempt organizations — looking to provide additional financial incentives and protections for their top executives and key employees. Prior to the 2003 overhaul of split dollar regulations, the most popular form of split dollar was undoubtedly an equity collateral assignment arrangement, where executives could limit their income-tax exposure to economic benefit costs by accessing a life insurance policy's equity income-tax free (equity being the policy's cash value beyond cumulative premiums paid). With the enactment of the "new" split dollar regulations in 2003, however, which strictly prohibit these former equity arrangements, many believed that split dollar was no longer a viable planning technique in the executive-benefit space.

But, just as the proverbial phoenix rises from the ashes, so too does split dollar — just with a new set of feathers. For as interest rates have fallen and remained at historic lows over the last several years, split dollar loans have become an attractive replacement for the former equity collateral assignment arrangements. And, with the enactment of the excise tax under IRC §4960, which imposes a 21% tax on tax-exempt organizations for compensation paid over a $1M to certain employees, split dollar loans offer these entities an attractive alternative to traditional 457(f) plans.



When does the excise tax apply?

Section 4960 provides that any remuneration above $1M paid to a covered employee by applicable tax-exempt organizations (ATEOs), or related organizations, is subject to an excise tax equal to the rate of tax imposed on corporations (currently 21 percent). Let's define some of these terms:

An ATEO

Includes organizations exempt from tax under §501(a) (e.g., 501(c)(3) organizations), certain government entities that exclude tax under §115(1), political organizations described in §527(e)(1) and farmers' cooperatives described in §521(b)(1). Common organizations with highly compensated employees that qualify as ATEOs include certain hospitals, colleges and universities, and large charitable organizations. Interestingly enough, the IRS recently confirmed that certain government entities, including state colleges and universities, that do not get their tax exemption under §501(a) and do not exclude income under §115(1), are not considered ATEOs and would be exempt from this tax. See *Notice 2019-09*.

Remuneration

Is defined generally as wages and amounts required to be included in gross income under §457(f), but does not include remuneration paid to a licensed medical professional (including veterinarians) for medical/veterinary services provided by such individual.

A covered employee

Means a current or former employee of the ATEO who is either one of the five highest-compensated employees in the organization for the taxable year OR was a covered employee of the organization for any preceding taxable year after 2016.

Example
Michael is CEO of a tax-exempt organization that qualifies as an ATEO. In 2020, Michael will earn $750,000 in wages and will also receive a $1M lump-sum payout from his 457(f) deferred compensation plan. Michael is the highest-paid current employee of the organization and qualifies as a covered employee. Under §4960, the ATEO will have to pay an excise tax equal to $157,500 [($1,750,000 - $1,000,000) * 21%] based on Michael's 2020 remuneration.

How can split dollar loans mitigate this tax?

Because the excise tax affects all renumeration exceeding $1M, including payouts from 457(f) plans (with no grandfathering allowed), ATEO employers are looking for alternative deferred benefit arrangements that can mitigate or eliminate this excise tax while still providing robust supplemental income benefits and cost recovery. Enter split dollar loans.

In a split dollar loan arrangement, the ATEO employer pays the premiums on behalf of the executive who purchases and owns a life insurance policy on his/her own life. Each premium payment is structured as a loan, with a specified loan term and corresponding interest rate. While the premium loans remain outstanding, the interest due on the loans is either imputed into the executive's income, paid out-of-pocket by the executive or deferred and added to the loan balance. At the end of the loan term — which may be on demand, after a term of years, upon the executive's death or a hybrid of these — the outstanding loan balance is repaid to the organization via the policy's cash value, death benefit, or via forgiveness of the debt (the latter of which would constitute taxable compensation).

If the loans are properly structured under the split dollar loan rules (see Treasury Regulations 1.7872-15), all premium payments lent to the executive would not constitute remuneration under §4960. This affords ATEOs the ability to fund large life insurance policies designed to maximize cash value growth without creating taxable income to the executive and liability for the excise tax at the time of funding. Moreover, so long as the policy’s cash value and/or death benefit is sufficient to ensure repayment of the cumulative loans and accrued interest, the executive can access the cash value tax-free (via policy loans and withdrawals) during retirement years to mimic/replace the benefit that might otherwise have been paid via a 457(f) plan.

By using a split dollar loan strategy, ATEO employers can mitigate or even eliminate their exposure to the §4960 excise tax, while their executives can substantially reduce the tax liability associated with the benefit being providing during retirement.

Where can I learn more?

- To learn more about split dollar loans, how they work and important considerations, check out our **Corporate Split Dollar Client Guide**
- For more information about 457(f) plans, check out our **Non-Qualified Deferred Compensation for Non-Profits — IRC §457 Plans BYA**
- To see how this planning technique was used in a recent case, check out our **Planning in Action**

To have a member of the our Advanced Markets team run a custom split dollar loan illustration, call *888-266-7498, option 3* or email *advancedmarkets@jhancock.com*