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How Split-Dollar Life Insurance Rescues Nonprofits

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▶ Addressing the excise tax on compensation paid to nonprofits' key employees.

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People might be surprised to learn that the tax reform of 2017 imposed an excise tax on nonprofit employees paid more than \$1 million in parachute payments.

The surprise for many people is that a nonprofit firm may have several employees impacted by this 21% excise tax, especially if the nonprofits that come to mind are those like the local YMCA or Girl Scout council.

But what about the leader of a large health care organization, the head of a major foundation or the CEO of a major credit union? These positions at tax-exempt organizations are widely understood to have compensation and benefit packages that could trigger the tax.

It should not come as a surprise that the excise tax is causing financial concern. It also calls attention to compensation arrangements and is creating problems of perception and appearance for stakeholders, legislators and the public.

Nonprofits and other tax-exempts were already at a disadvantage in competing for talent with for-profit corporations. This excise tax has worsened the ability for tax-exempts to recruit, retain, reward and provide for the retirement of key executives.

As a result, tax-exempt organizations are increasingly using split-dollar life insurance arrangements as alternatives to traditional nonqualified deferred compensation plans.

Before the 2017 Tax Cuts and Jobs Act, this approach was already a popular strategy for tax-exempt organizations.

Perhaps the two most prominent examples are Jim Harbaugh at the University of Michigan and Dabo

Swinney at Clemson University, two high-profile college football coaches receiving split-dollar life insurance arrangements as part of their compensation packages.

Split-Dollar Life Insurance

Under a split-dollar loan arrangement, the employer agrees to make loans to the executive to pay the premium on a cash value life insurance policy that is owned by the employee. The policy is collateral assigned to the employer to secure the repayment of the loan from the policy's cash value, death benefit or both.

Policies funding split-dollar plans are generally designed to maximize cash value accumulation and minimize the

amount of death benefit purchased unless there is a greater need for it.

With the enactment of the 21% excise tax, split-dollar loan arrangements have become more attractive because premium loans are not considered wages. If they are treated as loans for federal tax purposes, then they are not remuneration subject to the 21% tax.

"Split-dollar is a strategy that allows the disproportionate sharing of the cost and benefits of a permanent life insurance policy between two persons," said Michael Fontanini, vice president, advanced sales and design, with Lion Street. "The premium loans made to the employee accumulate cash value policy which can later be accessed in retire-

Who Is Affected By The Excise Tax?



The definition of a **"covered employee"** comprises more than officers. It includes a current or former employee who is or was among the five highest paid in a tax year beginning after Dec. 31, 2016.

Once an employee is deemed a "covered employee," they will always be considered a "covered employee" and therefore the number of affected employees is not limited after the first year to just five. Even after retirement, the excise tax could be triggered by a deferred compensation payment to a former employee.



Don Curristan is a principal of the national executive benefit planning firm Executive Benefit Solutions and works with dozens of tax-exempt organizations on their executive compensation strategies.

"You can see how a lump-sum payment under a traditional \$457(f) plan can inadvertently trigger the excise tax for someone who is a senior employee but not an officer," he said. "The excise tax is owed by the employer and not the employee, which puts the pressure on the employer to take steps to not trigger the tax."

There are a few exemptions to who is a "covered employee" for purposes of the excise tax. Remuneration paid to licensed medical professionals, including physicians, nurses and veterinarians, for their professional medical services is excluded. However, if one of these medical professionals is serving in an administrative function such as executive or medical director at a nonprofit hospital, then the remuneration linked to that position is included.

ment tax-free as withdrawals or loans from the policy. The tax-exempt employer recovers its loans, plus any accrued interest, from the death benefit, and any remaining death benefit proceeds are paid to the employee's beneficiaries."

Note that the nature of the split-dollar loan is important and that any imputed income attributable to below-market loans would be treated as compensation and could be subject to the excise tax. If the loans bear a market rate of interest, equal to or more than the Applicable Federal Rate, that is appropriately paid or accrued, the Internal Revenue Code generally does not apply and there is typically no imputed income.

Further, if the loan is designed to be below market, it should be either a demand or hybrid term loan. These types of loans recognize the income annually at the time it would otherwise be due. Care should be taken to ensure any split-dollar loans are structured properly to obtain the optimal tax treatment.

Evolution Of Split-Dollar

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 past 17 years. In 2003, the IRS issued comprehensive split-dollar regulations that clarified the tax treatment of arrangements commonly used at that time and those entered into thereafter.

Under current tax law, the split-dollar form that is the most commonly used in the context of compensation and benefits planning for nonprofit organizations is the loan regime/collateral assignment arrangement. The loans made to the employee for policy premiums allow the employer to retain a security interest in the policy values via the collateral assignment. This assignment is released at the time of repayment, which is typically at termination of employment or at death.

Although the interest on the loan may be paid annually by the employee, usually the interest is either imputed to them as compensation annually, in which case the employee is taxed on the interest annually, or the interest is accrued and repaid at termination or death. Unless structured as demand or hybrid term loans, below-market loans charging inadequate interest should be avoided, as

the imputed income from traditional term loans with a period certain at the month the loan is made is equal to the present value of all the forgone interest over the term of the loan, discounted at the appropriate AFR.

Scott Richardson is the CEO and founder of IZALE Financial Group and regularly structures split-dollar plans for credit unions and other nonprofit associations. "How the loan is structured is important in modeling plan costs," he said. "Loans can be made as demand or term loans or a hybrid of the two."

Demand notes are repayable on demand by the lender and will utilize the Blended Annual Rate equal to the average of the Short-Term Applicable Federal Rate for January and July each calendar year as published by the IRS in June.

A term loan uses the appropriate AFR in effect the month the loan is made and based on and locked in for the stated or deemed term of the loan. The Short-Term AFR is for loans up to three years, Mid-Term AFR for loans between three and nine years, and Long-Term AFR for those over nine years. A hybrid loan is a term loan that is payable on death, separation from service or the earlier of death and a period certain. With any term loan, each advance is a new loan subject to a new AFR based on its term.

A technique Richardson often employs with credit unions is for the employer to make a single, up-front term loan to the employee repayable on death, the excess proceeds of which over the first-year premium are held in the life insurance company's premium deposit account. This allows the AFR on the entire loan funding all premiums to be locked in for the loan's term, which is often until death of the insured. "The life insurance company then moves funds from the premium deposit account annually in years 2+ to make premium payments on the policy," he said.

Reporting

An "Organization Exempt from Income Tax" as defined by the IRS must annually file a Form 990. The organization is required to report compensation for current officers and key employees in Part IX, Statement of Functional Expenses, Line 5, using the total compensation paid to such individuals for the organization's

fiscal year, which may be different from the calendar year.

"Under a loan-regime split-dollar arrangement, any outstanding loans made to and owed by a key employee of a tax-exempt organization are reported elsewhere in Schedule L," said Janice Forgays, estate and wealth counsel at PRW Wealth Management. "Only the small, annual interest costs imputed to the executive as compensation, if any, are reported on Schedule J."

Forgays offered a word of caution to organizations implementing a split-dollar plan. "In order to avoid the appearance of a private inurement, all the formalities of adopting a compensation plan must be followed. These include a written plan and a formal adoption by the board."

2020 IRS Proposed Regulations

On June 11, 2020, the Treasury Department and the IRS released detailed proposed rules interpreting §4960 of the IRC. The proposed regulations provide additional detail about the tax penalties on tax-exempt employers and entities treated as related to those organizations paying certain employees remuneration in excess of \$1 million or excess payments contingent upon an employee's separation from employment.

The most helpful parts of the proposed regulations are in defining who is or is not a covered employee, which includes a number of exemptions, what is or is not an Applicable Tax-Exempt Organization, and what is or is not considered remuneration subject to the excise tax.

The proposed regulations touched upon the use of split-dollar arrangements as they pertain to the §4960 excise tax. The regulations provide that imputed interest on a below-market split-dollar loan (in which the insurance arrangement is structured using the loan approach) is treated as remuneration under these rules, even though there is no federal tax withholding on the interest. Until final regulations are issued, an organization may rely on these proposed regulations, or the organization may adopt its own reasonable, good faith interpretation of the statutory rules.

Administration

As with any benefit plan, success can hinge upon the quality of the plan's

What Organizations Are Subject To The Excise Tax?



The excise tax applies to an **“applicable tax-exempt organization.”** This definition encompasses all types of tax-exempt organizations whose income is excluded from taxation under §501(a), including **hospitals, colleges, and universities** exempt under §501(c)(3), **health maintenance organizations** and other **social welfare organizations** exempt under §501(c)(4), **labor and agricultural organizations** exempt under §501(c)(5), and **labor organizations, chambers of commerce, real estate boards** and **professional sports leagues** exempt under §501(c)(6). The excise tax also applies to **organizations** that have their income excluded from taxation under §115(1), **farmers’ cooperatives** described in §521(b)(1) and **political organizations** described in §527(e)(1).

Despite their tax-exempt status, **many state colleges and universities** whose income is exempt from taxation under the doctrine of implied statutory immunity **are not subject to the excise tax.** In 2019, the U.S. Treasury clarified this distinction with IRS notice 2019-09, which provides that a governmental unit that is not recognized as tax exempt under Section 501(a) of the Code and does not exclude income under Section 115(1) of the Code is not an applicable organization.

administration. A company’s benefit employees will change over time, and a record of not only why a split-dollar plan was implemented but the intent of the plan for both the employer and the employee is crucial.

Jordan Walker, manager of business insurance solutions for Lincoln Financial Distributors, said that administration should cover two things: accounting of the plan and management of the policy.

“An experienced administration partner is key when it comes to split-dollar arrangements. There are so many instances where the plan is well-documented and monitored but the life insurance policy funding vehicle does not receive ongoing evaluation,” he said. “As with any life insurance policy, performance can vary, so premiums may have to be increased or decreased to preserve both the employee’s expectation of future payments and

the employer’s ability to recover.”

Walker focuses on making sure the future intent of the executive is considered when designing split-dollar arrangements. The executive may wish to use the policy for estate planning as opposed to taking policy loans for supplemental retirement income, and this may impact how the policy is owned. This means considering trust ownership or other positioning of the policy.

“It is easy for an employer to focus on their side of the equation and to zero in on a split-dollar plan’s ability to recover the loans advanced at any time during the plan. Equally as important is the need to balance that protection of the organization with the plan’s benefits for the executive.”

Considerations

Although split-dollar plans have

increased in application with tax-exempts, a variety of plans should be evaluated to find if one or a combination of them is the best fit. All tax-exempt organizations with executive benefit plans should immediately revisit and reconsider the financial effectiveness of their plans. A split-dollar loan arrangement may be the solution. [in](#)

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