Executive Benefits for Nonprofit & Tax-Exempt Organizations

Recruit, Retain, and Reward Your Top Talent with Nonqualified Retirement or Estate Planning Benefits
As a nonprofit or tax-exempt organization, you are often challenged by the same question facing all successful businesses:

How do we keep our most talented people from leaving to work elsewhere?

As you probably know, the challenge to keep talented executives is even greater for nonprofit organizations than for ordinary businesses. Like for-profit businesses, nonprofit and tax-exempt organizations are limited as to the types of benefits they can offer key executives. But benefits offered by nonprofit organizations may also be subject to specialized tax rules under Section 457 and Section 409A of the Internal Revenue Code. In particular, benefits from arrangements covered by section 457(f) must be subject to a “substantial risk of forfeiture.” According to IRC § 457(f)(3)(B), a benefit is “subject to a substantial risk of forfeiture if such person’s rights to such compensation are conditioned upon the future performance of substantial services by any individual.”

The good news is that these limitations are not the end of the story. Fortunately, there are alternative plan designs available to nonprofit and tax-exempt organizations which are not governed by §§ 457 or 409A. Understanding how these alternative plan designs work can help your organization recruit and retain key executives and directors.

Depending on the needs of the executive or director involved, nonprofit organizations might consider one of the following five plan designs for offering nonqualified retirement benefits:

- § 457(f) Plans
- Split Dollar Loans
- Split Dollar Loan/§ 457(f) Combo Arrangements
- Executive Bonus Plans
- Restricted Executive Bonus Arrangements (“REBAs”).

But sometimes key executives or directors of nonprofits have little or no need for additional retirement benefits. Working for the nonprofit organization may be a second career and/or they may have already accumulated sufficient assets for retirement. In these cases, the executive or director might be more interested in a benefit that can help provide funds for estate planning.

Where an executive or director’s primary concern for benefits is estate planning, your organization may want to consider one of the following plan designs:

- Non-Equity Collateral Assignment Split Dollar Arrangements
- Split Dollar Loans.

¹For the purposes of this brochure, both the terms “nonprofit” and “tax-exempt” refer to organizations which qualify for tax-exempt status under section 501(c) of the Internal Revenue Code.
Plan Types for Retirement Benefits Using Life Insurance

The following arrangements offer insurance and retirement benefits which tax-exempt entities can use to recruit, reward, and retain key talent. Two considerations may be particularly important to employers when choosing a plan design: (i) “Golden Handcuffs,” and (ii) cost recovery.

One of the key objectives for a tax-exempt entity in offering insurance and retirement benefits is providing the employee or director with an incentive to remain with the organization. An arrangement which offers financial incentives to stay with the organization for an agreed upon period of time (or which applies financial disincentives to an early departure) is said to have “Golden Handcuffs.”

Alternatively, a tax-exempt employer may be unwilling to offer an insurance or retirement benefit to an employee or director unless the organization can recover some or all of the money it invests in providing the benefit. Such arrangements are said to provide an element of cost recovery.

Section 457(f) Plans

A § 457(f) plan is a nonqualified deferred compensation arrangement for nonprofit and tax-exempt organizations which provides tax deferral on unlimited amounts for executives willing to subject benefits to a “substantial risk of forfeiture.” These arrangements may be informally funded with life insurance on the executive which is purchased and owned by the tax-exempt organization with death benefits payable to the organization.

These plans may be suitable where:
- The organization wants “Golden Handcuffs” for the executive;
- The executive wants tax deferral; and
- The organization wants a potential source of cost recovery for the benefit.

Split Dollar Loans

A split dollar arrangement with “loan” treatment is an arrangement where the organization pays premiums to fund a life insurance policy for a key executive, but retains an interest in the policy equal to the sum of premiums advanced with the right to be repaid at some point in the future (e.g., at retirement or death). The parties file a collateral assignment with the insurance company to provide security for the organization’s interest in the policy.
The executive is taxed on the “imputed interest” from treating the organization’s premium payments as a series of loans for income tax purposes. The life insurance policy can be used by the executive for death benefit protection and as a potential source of supplemental retirement income, by using a combination of loans and withdrawals.²

These plans may be suitable where:
- The executive wants flexibility;
- The executive wants control of the insurance policy; and
- The organization wants a potential source of cost recovery for the benefit.

Split Dollar Loan/§ 457(f) Combo Arrangements

A split dollar loan/§ 457(f) combo arrangement is essentially a split dollar loan arrangement where the organization makes an additional promise to release its interest in the split dollar life insurance policy at retirement or some other specified date. This promise by the organization to release its interest in the split dollar loan arrangement must meet the requirements of both §§ 457(f) and 409A. This technique is sometimes referred to as a split dollar “rollout.”

These plans may be suitable where:
- The executive wants flexibility;
- The executive wants control of the insurance policy; and
- The organization wants “Golden Handcuffs” for the executive.

Executive Bonus (§ 162) Plans

An executive bonus arrangement provides a cash value life insurance policy for executives using after-tax dollars contributed by the organization. The organization pays premiums on a life insurance policy owned by the executive and treats the premium payments as bonuses. The executive acquires a potential source of flexible, tax-preferred supplemental retirement income as well as death benefit protection on an after-tax basis.³

These plans may be suitable where:
- The executive wants flexibility and does not need to defer taxable receipt of income;
- The executive wants control of the insurance policy; and
- The parties want a simple arrangement.

Restricted Executive Bonus Arrangements (REBAs)⁴

A Restricted Executive Bonus Arrangement (“REBA”) is an executive bonus arrangement which uses a supplemental employment agreement to tie the executive closer to the organization. The supplemental agreement may require the executive to pay back some or all of the organization’s premium advances in the event the executive leaves. A restrictive endorsement can be placed on the policy, limiting the executive’s ability to access cash values without the consent of the organization.

These plans may be suitable where:
- The executive wants flexibility;
- The executive wants control of the insurance policy;
- The parties want a simple arrangement; and
- The organization wants “Golden Handcuffs” for the executive.

² Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).

³ A portion of the policy’s surrender value may be available as source of supplemental retirement income through policy loans and partial withdrawals. Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).

⁴ This description of a REBA arrangement assumes that income taxation is pursuant to IRC sections 61 and 162 and is not subject to IRC sections 409A or 83. A REBA may also be subject to ERISA plan requirements. Clients should seek advice from their tax and legal advisors.
Plan Types for Estate Planning Benefits

Non-Equity Collateral Assignment Split Dollar Arrangements

A non-equity collateral assignment split dollar arrangement allows an executive’s irrevocable life insurance trust (“ILIT”) to own the net death benefit (i.e., the death benefit in excess of the premiums which have been assigned back to the employer) of a life insurance policy paid for by the employer. This is an arrangement of shared ownership of a life insurance policy where the nonprofit organization pays all of the policy premiums.

The organization pays the premiums on a life insurance policy purchased and owned by the executive’s ILIT, but reserves the right to be repaid the greater of the policy’s cash value or the total premiums paid into the policy. The ILIT gives the organization a collateral assignment for an interest in the policy equal to the greater of the policy’s cash value or the sum of premiums the organization has paid.

The executive is taxed each year on the “economic benefit” of receiving life insurance coverage for that year. This benefit is measured by applying rates the IRS uses to determine how much an individual would have to pay for term life insurance coverage for the amount of the split dollar benefit or, if lower, the insurer’s published one year term rates available to all standard risks.

Since estate planning is an objective of the arrangement, the split dollar arrangement will need to be executed between the organization and an ILIT created by the executive. In order to keep the proceeds of a life insurance policy outside of the estate, the executive must not have any “incidents of ownership” in the policy. Incidents of ownership include the right to withdraw or borrow money from a policy, the right to surrender a policy, and the right to change the designated beneficiaries of a policy. Thus, to avoid incidents of ownership, the split dollar agreement is executed directly with the executive’s ILIT.

Additionally, the executive is considered to have made a gift to the ILIT of the right to receive the death benefits. This gift is measured annually using the same economic benefit amount that is used for income tax purposes.

Split Dollar Loans for Estate Planning

A split dollar arrangement with “loan” treatment is an arrangement where the organization pays premiums to fund a life insurance policy for a key executive, but retains an interest in the policy equal to the sum of premiums advanced with the right to be repaid at some point in the future (e.g., at retirement or death). Rather than being owned by the executive outright, the policy is purchased by an irrevocable life insurance trust (“ILIT”) which the executive establishes for estate planning purposes. The parties file a collateral assignment with the insurance company to provide security for the organization’s interest in the policy. The executive is taxed on the “imputed interest” from treating the organization’s premium payments as a series of loans. The organization’s premium payments will be reimbursed at the termination of the split dollar loan arrangement.

As is the case with non-equity collateral assignment split dollar, where a split dollar loan arrangement is used for estate planning, the transaction will have gift-tax consequences. Because the policy is owned by an ILIT, the executive will be making annual gifts. The gift amount will be the same as the amount imputed to the executive as income—i.e., the gift to the ILIT is the amount of interest imputed on the loan.

Once the loan has been repaid, there are no further gifts to the ILIT unless the policy needs additional premiums. If more premium payments are needed to sustain the policy in retirement, the executive will have to make gifts to the trust.
Summary

The following table provides a summary of the arrangements that may be appropriate for accomplishing specific objectives.

<table>
<thead>
<tr>
<th>Objective</th>
<th>Plan Type(s)</th>
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<tbody>
<tr>
<td><strong>Tax Deferral for the Executive</strong></td>
<td>§ 457(f)</td>
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</table>
| **Avoid Substantial Risk of Forfeiture** | Split Dollar Loans  
Executive Bonus  
REBA |                                                      |
| **Flexibility**                    | Split Dollar Loans  
Split Dollar Loan/§ 457(f) Combo  
Executive Bonus  
REBA |                                                      |
| **“Golden Handcuffs”**             | § 457(f)  
Split Dollar Loan/§ 457(f) Combo  
REBA |                                                      |
| **Cost Recovery for the Organization** | § 457(f)  
Split Dollar Loans |                                                      |
| **Estate Planning**                | Non-Equity Split Dollar  
Split Dollar Loans |                                                      |
| **Simplicity**                     | Executive Bonus  
REBA |                                                      |

Your financial professional has specialized tools available to help you select an insurance arrangement to help you meet your organization’s need to recruit, retain, and reward your most important employees.

ERISA and Executive Benefits

The Employment Retirement Income Security Act of 1974 (ERISA) is a federal law that regulates the funding by employers of certain “employee benefit plans.” A plan that is subject to some or all of ERISA’s provisions may be required to meet, for example, minimum funding and vesting standards. In addition, the person or entity responsible for managing plan assets may be required to satisfy specified fiduciary obligations. Depending upon the circumstances, one or more of the executive benefit designs discussed above could fall within the meaning of an “employee benefit plan.” However, if structured properly, an executive benefit design can avoid many, if not most, of the more onerous ERISA requirements. Employers who adopt executive benefit plans should meet with ERISA counsel so that the plan can be designed with the needs of the employer and executive in mind.

Income Tax-Free Life Insurance Distributions

Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans.5

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5 Policy loans and partial withdrawals may vary by state, reduce available surrender value and death benefit or cause the policy to lapse. Generally, policy loans and partial withdrawals will not be income taxable if there is a withdrawal to the cost basis (usually premiums paid), followed by policy loans (but only if the policy qualifies as life insurance, is not a modified endowment contract and is not lapsed or surrendered).
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