Executive Benefits for Nonprofit & Tax-Exempt Organizations

Producer Guide

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There is a key question on the minds of nonprofit and tax-exempt organizations. It is the same question facing all successful businesses:

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

Just like their for-profit counterparts, nonprofit organizations are seeking ways to recruit, reward, and retain key executives. But the challenge to keep executives is even greater for nonprofit organizations because, unlike ordinary corporations, benefits offered by nonprofits must, with some exceptions, meet the restrictions of both IRC § 457 and IRC § 409A.

The good news for you and for nonprofit organizations 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 you to help nonprofit organizations recruit and retain key executives and directors.

Depending on the needs of the executive or director involved, nonprofit organizations might consider 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”).

Alternatively, if the executive or director’s primary concern is estate planning, the nonprofit organization may want to consider one of the following options:

- Non-Equity Collateral Assignment Split Dollar Arrangements
- Split Dollar Loans
Factors to Consider

An important key to selecting the right retirement benefit design will be to determine which of the following factors are most important to the organization and the executive: (i) tax deferral for the executive; (ii) avoiding a “substantial risk of forfeiture;” (iii) flexibility; (iv) “Golden Handcuffs;” or (v) providing potential cost recovery to the organization.

Tax Deferral

Sometimes the primary reason for implementing a nonqualified plan is to allow executives to defer taxation on income until the money is actually needed (i.e., not pay taxes on a benefit until retirement). For executives of nonprofit and tax-exempt organizations, benefits which offer tax deferral must generally comply with IRC §§ 457 and 409A.

Avoiding “Substantial Risk of Forfeiture”

The price to the executive for unlimited contributions and tax deferral is that the benefit must be subject to a “substantial risk of forfeiture.” Many executives and directors may prefer to seek a benefit arrangement which avoids this requirement.

In order for a nonqualified benefit that exceeds the § 457(b) contribution limits to provide tax deferral for executives or directors of nonprofit organizations, § 457(f) requires the benefit to be subject to a “substantial risk of forfeiture.” According to § 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.” In practical terms this means that tax deferral is available to executives and directors of nonprofit organizations only where the benefit does not vest until it is paid out and the benefit is likely to be paid out in a lump sum.

Flexibility

As was indicated above, for all practical purposes, benefits which allow executives of nonprofits to defer taxation will be paid out in a lump sum. This is because such benefits will be fully taxable under § 457(f) as soon as there is no longer a substantial risk of forfeiture. Thus, once a benefit has vested, the IRS will require the executive to recognize the full amount of the benefit as ordinary income even if the benefit is scheduled to be paid out over a period of years. Executives and directors who want to be able to take payments in forms other than a lump sum, or who want the ability to change the schedule of payments, will seek a plan design that is not subject to the restrictions of § 457(f).

“Golden Handcuffs”

One of the primary reasons for employers to implement nonqualified plans is to provide incentives that will help retain key executives. Where a benefit is tied directly to a requirement that the executive continue working for the employer, the arrangement is said to have “Golden Handcuffs.”

Cost Recovery

Some nonprofit or tax-exempt organizations will not be interested in offering benefits to key executives unless they can potentially recover some or all of the costs of providing those benefits.

Estate Planning

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

Simplicity

Nonqualified plans such as § 457(f) arrangements and split dollar loan/§ 457(f) combo arrangements can require significant plan administration (perhaps even requiring a third-party administrator). These arrangements can also require complex legal agreements which must comply with § 409A. Other nonqualified plans, such as executive bonus arrangements and REBAs, require little or no plan administration.
Nonqualified Retirement Benefits

The following plan designs can be used by nonprofit organizations to provide nonqualified retirement benefits to key executives and directors.

Section 457(f) “Ineligible” Plans

A § 457(f) plan is a nonqualified deferred compensation arrangement for nonprofit and tax-exempt organizations which provides tax deferral on unlimited contributions for executives willing to subject benefits to a “substantial risk of forfeiture.”

These plans may be suitable where:

- The nonprofit organization wants to give the executive or director an incentive to remain with the organization (“Golden Handcuffs”);
- The executive wants tax deferral; and
- The organization wants a potential source of cost recovery for the benefit.

Steps for Implementing § 457(f) Plans

1. The nonprofit organization and the executive agree that supplemental retirement income is an important component of the executive’s total compensation package. The parties execute a § 457(f) agreement that spells out the benefits promised to the executive and upon what conditions such benefits will be paid.

2. The organization acquires a cash value life insurance policy on the executive’s life.

3. The organization pays premiums on the life insurance policy. These premium payments are not deductible to the organization, nor are they treated as income to the executive (so long as the arrangement complies with §§ 457(f) and 409A).

4. At the executive’s retirement, the organization may use any available policy cash values to pay the benefit promised to the executive. Alternatively, in the event of a premature death, the death proceeds of the policy can be used to provide benefits to the executive’s survivors.

- The retirement payments will be treated as ordinary income to the executive;
- Death benefits paid to the executive’s survivors are also treated as ordinary income (I.R.D).

5. At the executive’s death, the death benefit proceeds can be used by the organization to potentially recover the costs of the arrangement.
Advantages
- Tax deferral for the executive
- Provides a potential source of supplemental retirement income
- “Golden Handcuffing”
- Potential cost recovery available to organization

Disadvantages
- Subject to §§ 457 and 409A
- Subject to “substantial risk of forfeiture”
- Retirement benefits are subject to income taxes
- Benefit must be paid in a lump sum
- Death benefit paid to executive’s survivors is taxable as ordinary income

Detailed Analysis
Section 457(f) plans are arrangements where an employer promises to pay an executive a future benefit. The benefit may be based on deferrals made to the plan by the executive or may promise a benefit amount based on years of service, reaching retirement age, or at death. In both types of arrangements, the executive does not pay income taxes until the benefits are paid out. Organizations will typically purchase a life insurance policy to provide a source of funds that will be needed to pay the promised benefits. These plans are subject to the requirements of IRC § 409A.

In addition, § 457(f) plans are subject to the “substantial risk of forfeiture” rules. For these plans, “compensation shall be included in the gross income of the participant or beneficiary for the first taxable year in which there is no substantial risk of forfeiture.” IRC § 457(f)(1)(A). This means, in essence, that once benefits become vested they must be included in income. As a consequence of the substantial risk of forfeiture requirements, § 457(f) plans are generally designed to pay a lump sum amount at retirement or some other specified vesting date.

The substantial risk of forfeiture must be employment related. It must be “conditioned upon the future performance of substantial services.” IRC § 457(f)(3)(B). This means that an executive will not be able to defer taxation in an ineligible § 457(f) plan unless he or she is willing to commit to remaining with the organization until a specified date and is willing to give up all of the benefits if he or she doesn’t remain that long. This risk of forfeiture may make an ineligible plan unacceptable to many executives.

Split Dollar Loan Arrangements
A split dollar arrangement with “loan” treatment is an arrangement where the organization’s dollars are used to fund the purchase of life insurance for a key executive with retention by the organization of an interest in the policy equal to the sum of premiums advanced and where the executive is taxed on the “imputed interest” from treating the organization’s premium payments as a series of loans. The life insurance policy can be used by the executive for death benefit protection and as a supplemental source of retirement income.

These plans may be suitable where:
- The executive wants flexibility;
- The executive wants control of the funding policy; and
- The organization wants a potential source of cost recovery for the benefit.
Steps for Implementing Split Dollar Loan Arrangements

1. The organization identifies a need to retain and reward a key executive. The organization and the executive agree that personal life insurance protection and the related cash value accumulations are important components of the executive’s overall compensation package. The parties execute a split dollar agreement setting forth their rights and obligations.

2. The executive acquires a cash value life insurance policy on his or her life and executes a collateral assignment with the Voya life company indicating the policy rights reserved to the employer.

3. The organization makes premium payments on the policy.
   - The premium payments are treated as below market loans from the organization to the executive;
   - Each year, the executive is taxed under IRC § 7872 on the amount of interest imputed by the IRS on the sum of premiums that have been advanced;
   - The organization retains a collateral assignment interest in the policy equal to the sum of premiums advanced.

4. At retirement, the split dollar arrangement is terminated and the organization recovers its premiums from the executive. The executive may reimburse the organization by accessing any available policy cash values through withdrawals or using out-of-pocket funds from an outside source.

5. After termination of the split dollar loan arrangement, any remaining policy cash values are available on a tax-preferred basis to supplement the executive’s retirement income by using a combination of loans and withdrawals. The policy death benefit will be paid income tax-free to the executive’s beneficiaries, absent a transfer for value.

Advantages

- Provides a potential source of tax-preferred supplemental retirement income*
- Not subject to § 409A rules
- Not subject to substantial risk of forfeiture
- Flexibility on timing of distributions
- Death benefit not taxable as income**
- Permits potential cost recovery to organization

Disadvantages

- Executive taxed annually on "imputed interest"
- Cash value of policy reduced by premiums paid back to organization
- No “Golden Handcuffing”

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* The policy’s cash values are available to the executive as a source of supplemental retirement income through loans and withdrawals. Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

** Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from estate tax.
Detailed Analysis

In a split dollar loan arrangement, the organization rewards the executive by advancing the premium costs for a life insurance policy purchased by the executive. The executive owns the policy, but gives the organization a collateral assignment for an interest in the policy equal to the sum of premiums the organization has paid. The organization’s premium payments will be reimbursed at the termination of the split dollar loan arrangement. Unless the executive uses outside funds to reimburse the organization, this will reduce the cash value of the policy.

The premium payments made by the organization are treated as a series of “below market” loans and the executive must pay income tax on the “imputed interest.” Section 7872 of the Internal Revenue Code provides that where employees are allowed to borrow money at below market interest rates, the amount of interest saved on the transaction should be considered an element of compensation to the employee.

Thus, for example, assume an employer advances $1,000 towards the purchase of life insurance for an executive where the executive pays no interest and the fair market interest rate is 5.0 percent. Since the executive saves $50 in interest costs, the IRS imputes $50 of income to the executive.

While the executive must pay taxes on imputed interest, any cash build-up in excess of the organization’s interest in the policy grows income tax-free. Death benefits coming from split dollar loan arrangements are also income tax-free.

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 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 funding policy; and
- The nonprofit organization doesn’t need cost recovery.

Steps for Implementing Split Dollar Loan/§ 457(f) Combo Arrangements
1. The organization identifies a need to retain and reward a key executive. The organization and the executive agree that personal life insurance protection and the related cash value accumulations are important components of the executive’s overall compensation package. The parties execute a split dollar agreement setting forth their rights and obligations.

2. The organization implements a § 457(f) arrangement promising to pay the executive a benefit equal to the premiums the organization will invest in the split dollar loan arrangement. If desired, the organization can promise an additional “gross up” benefit to cover the executive’s tax costs from the arrangement.

3. The executive acquires a cash value life insurance policy on his or her life and executes a collateral assignment with the Voya life company indicating the policy rights reserved to the organization.

4. The organization makes premium payments on the policy.
   - The premium payments are treated as below market loans from the organization to the executive;
   - Each year, the executive is taxed under § 7872 on the amount of interest imputed by the IRS on the sum of premiums that have been advanced;
   - The organization retains a collateral assignment interest in the policy equal to the sum of premiums advanced.

5. At retirement, the split dollar arrangement is terminated. The § 457(f) arrangement provides the executive with the funds needed to reimburse the organization and release the collateral assignment on the life insurance policy.

6. After termination of the split dollar loan arrangement, any available policy cash values can be accessed on a tax-preferred basis to supplement the executive’s retirement income by using a combination of loans and withdrawals. The policy death benefit will be paid income tax-free to the executive’s beneficiaries, absent a transfer for value.

### Advantages

- Provides potential source of tax-preferred supplemental retirement income*
- Not subject to substantial risk of forfeiture
- Flexibility on timing of distributions
- Death benefit not taxable as income**
- Permits “Golden Handcuffing”
- Executive receives policy with full cash value intact at retirement

### Disadvantages

- Executive taxed annually on “imputed interest”
- § 457(f) benefit is subject to § 409A rules
- § 457(f) benefit is fully taxable to executive at retirement
- No cost recovery for organization

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* The policy’s cash values are available to the executive as a source of supplemental retirement income through loans and withdrawals. Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

** Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from estate tax.
Detailed Analysis

The organization’s dollars are used to fund the purchase of life insurance for a key executive with retention by the organization of an interest in the policy equal to the sum of premiums advanced and where the executive is taxed on the “imputed interest” from treating the organization’s premium payments as a series of loans.

Additionally, the organization and the executive enter into a § 457(f) arrangement that promises the executive a second benefit which the executive can use to repay the premiums owed to the organization at retirement. According to IRS Notice 2007-34, adding a § 457(f) benefit to the split dollar loan brings the entire arrangement under § 409A. Thus, the entire arrangement should be documented in writing and the timing for the forgiveness of the split dollar loan must meet the requirements for permissible distributions under § 409A.

The premium payments made by the organization are treated as a series of “below market” loans and the executive must pay income tax on the “imputed interest.” Section 7872 of the Internal Revenue Code provides that where employees are allowed to borrow money at below market interest rates, the amount of interest saved on the transaction should be considered an element of compensation to the employee.

At retirement, the executive uses the § 457(f) benefit to satisfy his or her obligations under the split dollar collateral assignment. The § 457(f) benefit (an amount equal to the premiums paid on the policy) will be treated as taxable income to the executive. This rollout arrangement vests the executive in the full cash value of the split dollar life insurance policy at retirement. The life insurance policy can be used by the executive for death benefit protection and as a supplemental source of retirement income.

Executive Bonus (§ 162) Arrangements

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 source of flexible, tax-preferred supplemental retirement income as well as death benefit protection on an after-tax basis.

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 funding policy; and
- The parties want a simple arrangement.

Steps for Implementing Executive Bonus (§ 162) Arrangements
1. The organization and the executive agree that personal life insurance protection and the related cash value accumulations are important components of the executive’s overall compensation package. Depending on the relationship between the parties, this understanding may be formalized through an optional employment agreement.

2. The executive acquires a cash value life insurance policy on his or her life.

3. The organization makes the premium payments on this policy, which are taxed as additional compensation to the executive and create a current deduction for the employer. Optionally, the organization may provide an additional cash bonus to the executive to cover the income tax associated with the premium payment.

4. The policy cash values are available on a tax-preferred basis to supplement the executive’s retirement income by using a combination of loans and withdrawals. The policy death benefit will be paid income tax-free to the executive’s beneficiaries, absent a transfer for value.

### Advantages

- Provides potential source of tax-preferred supplemental retirement income*
- Not subject to §§ 457 or 409A
- Not subject to substantial risk of forfeiture
- Flexibility on timing of distributions
- Death benefit not taxable as income**
- Simple agreement
- No plan administration required

### Disadvantages

- Immediate taxation to executive
- No “Golden Handcuffs”
- No cost recovery available to organization

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* The policy’s cash values are available to the executive as a source of supplemental retirement income through loans and withdrawals. Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

** Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from estate tax.

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### Detailed Analysis

Perhaps the simplest executive compensation strategy is to provide extra benefits through an executive bonus arrangement. A bonus is a benefit paid to an executive in addition to regular compensation. For taxable entities, a bonus is deductible under IRC § 162 if, in conjunction with the executive’s regular salary, the total compensation represents “a reasonable allowance for salaries or other compensation for personal services actually rendered.” IRC § 162(a)(1). While nonprofit organizations are not concerned with deductions, the same principles apply to this type of arrangement.

Bonus arrangements fall outside the purview of §§ 457 and 409A because they are not plans of deferred compensation. Bonuses are taxable in the year they are paid. The parties can arrange, however, to have the bonus funds directed to a tax-preferred investment vehicle to help fund retirement needs.

Bonus arrangements can be used to fund the purchase of life insurance for the executive. The organization simply pays the premiums on a policy owned by the executive and the executive recognizes the premium payments as ordinary income. If desired, the organization can give an additional bonus to the executive supplying the funds needed to pay income taxes incurred on the premiums (a “double bonus” or “gross up”).
When used to purchase life insurance, bonus arrangements can provide an excellent alternative to nonqualified deferred compensation arrangements for funding supplemental retirement needs. While the executive is taxed on the bonus, the funds are directed to life insurance, where they can grow tax deferred. With planning, the funds can be accessed during retirement on a tax-preferred basis. Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract. Finally, any death benefits received are income tax-free because the executive is the owner of the policy and was taxed on the premium payments.

The executive owns the underlying policy throughout the arrangement and there is no risk of forfeiture or exposure to creditors of the organization. On the other hand, the organization loses the potential to recover costs and has no “Golden Handcuffs” to motivate the executive to remain long term.

Restricted Executive Bonus Arrangements (REBAs)

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 funding policy;
- The parties want a simple arrangement; and
- The organization wants “Golden Handcuffs” for the executive.

Steps for Implementing REBAs

1. The organization and the executive agree that personal life insurance protection and the related cash value accumulations are important components of the executive’s overall compensation package. The parties execute a “supplemental employment agreement” setting forth their rights and obligations—including how long the executive commits to remain with the employer and an amount of “liquidated damages” for early departure.

2. The executive acquires a cash value life insurance policy on his or her life.

3. The executive and the organization execute a “restrictive endorsement” to the life insurance policy giving the employer a veto power over most decisions regarding ownership and administration of the policy cash values.
4. The organization makes the premium payments on this policy, which are taxed as additional compensation to the executive and create a current deduction for the employer. Optionally, the organization may provide an additional cash bonus to the executive to cover the income tax associated with the premium payment.

5. The “Golden Handcuffing” incentives provided by the supplemental employment agreement encourage the executive to remain with the employer for the agreed upon period of time. Following expiration of the agreed upon term, any available policy cash values can be accessed on a tax-preferred basis to supplement the executive’s retirement income by using loans and withdrawals. The policy death benefit will be distributed income tax-free to the executive’s beneficiaries, absent a transfer for value.

### Advantages
- Provides potential source of tax-preferred supplemental retirement income*
- Not subject to §§ 457 or 409A
- Not subject to substantial risk of forfeiture
- “Golden Handcuffing”
- Flexibility on timing of distributions
- Death benefit not taxable as income**
- No plan administration required

### Disadvantages
- Immediate taxation to executive
- Limited cost recovery available to organization

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* The policy’s cash values are available to the executive as a source of supplemental retirement income through loans and withdrawals. Income tax-free distributions are achieved by withdrawing to the cost basis (premiums paid) then using policy loans. Loans and withdrawals may generate an income tax liability, reduce available cash value and reduce the death benefit or cause the policy to lapse. This assumes the policy qualifies as life insurance and is not a modified endowment contract.

** Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from estate tax.

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### Detailed Analysis

A REBA is an executive bonus arrangement that makes use of a supplemental employment agreement to bind the executive to the organization. The REBA provides the same flexibility and tax treatment as an executive bonus arrangement, but adds the ability to provide an incentive to the executive to remain with the organization for a period of years.

The REBA has two primary components:

1. A life insurance policy with a restrictive endorsement; and
2. A supplemental employment agreement.

The organization pays the premium on a life insurance policy owned by the executive. In conjunction with this purchase, a restrictive endorsement is placed on the policy. The restrictive endorsement states that the executive has all ownership rights in the policy, but holds that the executive cannot access cash values without the consent of the organization. The Voya life companies have developed a “modification of ownership rights” form that can be used by an employer and executive to restrict access to a policy’s cash values. (Of course, the employer and executive should review the form with counsel to ensure that it meets their respective needs.)

The organization and the executive also execute a supplemental employment agreement. The agreement provides that the organization will pay the premium bonuses for the policy in exchange for the executive’s promise to continue working for the organization. The agreement provides that if the executive does not fulfill the obligations, he or she will repay some or all of the bonus back to the organization as “liquidated damages.” This provision protects the organization’s investment and gives the executive an incentive – or “Golden Handcuffs” – to stay with the organization.
Benefits for Estate Planning

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

The following benefits may be used to meet estate planning needs.

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 of a life insurance policy paid for by the organization. The organization pays all of the premiums on the 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 parties file a collateral assignment with the Voya life company which reserves the organization’s interest in the policy. The executive is taxed annually on the “economic benefit” of having life insurance coverage and the death benefits, when paid, are income tax-free to the executive’s designated beneficiaries. Additionally, by using an ILIT to own the policy, the death benefit may be moved outside of the executive’s taxable estate.

Steps for Implementing Non-Equity Collateral Assignment Split Dollar Arrangements

1. The organization, the executive, and the executive’s ILIT enter into a split dollar agreement where the ILIT is given the right to designate the beneficiary of the net death benefit of a policy purchased with premiums paid by the organization.
2. The ILIT purchases a policy insuring executive’s life.
3. The organization pays all premiums on the policy owned by the ILIT.
   - The executive is taxed annually on the economic benefit or term costs associated with the death benefit coverage.
   - The economic benefit or term costs are considered a taxable gift from the executive to the beneficiaries or the ILIT.
4. Upon the executive’s death, the insurance company pays a death benefit to the ILIT. These benefits are received income tax-free and, if proper steps were followed, estate tax-free. Any additional death benefit under the policy may be used by the organization to recover some or all of the costs of providing the benefit.
### Advantages
- Not subject to §§ 457 or 409A
- Not subject to substantial risk of forfeiture
- Death benefit paid to executive’s ILIT is income tax-free
- With proper planning, death benefit is received estate tax-free
- Cost recovery available to organization
- Simple plan administration

### Disadvantages
- Executive must pay income taxes on economic benefits or term costs each year
- Economic benefits or term costs are subject to gift taxes each year
- Economic benefit costs will increase as the executive gets older

### Detailed Analysis
A non-equity collateral assignment split dollar arrangement allows an executive’s irrevocable life insurance trust ("ILIT") to own the net death benefit of a life insurance policy paid for by the organization. The organization pays all of the premiums on the 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 will be taxed each year on the “economic benefit” of receiving life insurance coverage for that year. This benefit is measured by applying the rates of IRS Table 2001 to the death benefit amount the executive’s beneficiaries would receive if he or she died during that year.

*For example, assume Mr. Brown, age 50, has been promised the net death benefit for a $1 million life insurance policy where the employer has paid $300k in premiums and the current cash value is $400k. The net death benefit would be $600k ($1 million - $400k). Under IRS Table 2001, the economic benefit for a 50-year old is $2.30 per $1,000 of insurance. Therefore, Mr. Brown would pay income taxes on $1,380 of economic benefits income ($2.30 x 600).*

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.

*For example, assume Mr. Brown, age 50, has irrevocably assigned to his ILIT the net death benefit for a $1 million life insurance policy where the employer has paid $300k in premiums and the current cash value is $400k. The net death benefit would be $600k ($1 million - $400k). Under IRS Table 2001, the economic benefit for a 50-year old is $2.30 per $1,000 of insurance. Therefore, non-equity collateral assignment split dollar arrangement results in a gift to the ILIT of $1,380 ($2.30 x 600).*
Split Dollar Loans for Estate Planning

A split dollar arrangement with “loan” treatment is an arrangement where the organization’s dollars are used to fund the purchase of life insurance for a key executive with retention by the organization of an interest in the policy equal to the sum of premiums advanced and where the executive is taxed on the “imputed interest” from treating the organization’s premium payments as a series of loans. With proper policy design, split dollar loan arrangements can be used to provide a death benefit for estate planning purposes.

Steps for Implementing Split Dollar Loan Arrangements

1. The executive creates an ILIT which can be used to purchase life insurance outside of his or her estate.
2. The ILIT acquires a cash value life insurance policy on his or her life and executes a collateral assignment with the Voya life company indicating the policy rights reserved to the employer.
3. The organization, the executive, and the ILIT enter into a split dollar agreement where the organization agrees to pay premiums on the policy owned by the ILIT while retaining the right to be reimbursed for these premium advances at the executive’s retirement.
   - The ILIT also grants the organization a collateral assignment on the life insurance policy to secure the organization’s interest.
4. The organization makes premium payments on the policy.
   - The premium payments are treated as below market loans from the organization to the executive;
   - Each year, the executive is taxed under § 7872 on the amount of interest imputed by the IRS on the sum of premiums that have been advanced;
   - The organization retains a collateral assignment interest in the policy equal to the sum of premiums advanced.
5. At retirement, the split dollar arrangement is terminated and the organization recovers its premiums from the ILIT. The ILIT may reimburse the organization using withdrawals from the life insurance policy or using other assets.
6. Upon the executive’s death, the insurance company pays the death benefit to the ILIT. The ILIT receives this death benefit income tax-free and estate tax-free. The proceeds can then be used to lend funds to or purchase assets from the executive’s estate.
### Advantages
- Provides source of funds for estate planning
- Not subject to §§ 457 or 409A
- Not subject to substantial risk of forfeiture
- Death benefit not taxable as income
- Permits cost recovery to organization

### Disadvantages
- Executive taxed annually on “imputed interest”
- “Imputed interest” amount treated as taxable gift to ILIT
- Cash value of policy reduced by premiums paid back to organization
- No “Golden Handcuffing”

### Detailed Analysis

In a split dollar loan arrangement, the organization rewards the executive by sharing the costs of purchasing a life insurance policy for the executive. The executive purchases a life insurance policy and the organization pays the premiums. The executive owns the policy, but gives the organization a collateral assignment for an interest in the policy equal to the sum of premiums the organization has paid. The organization's premium payments will be reimbursed at the termination of the split dollar loan arrangement.

The key to making split dollar loans work as an estate planning tool is policy design. In order for the executive to provide liquidity to his or her estate, the policy will need to remain in force even after retirement. This means that the policy used in a split dollar loan arrangement should be designed to sustain itself after the organization has been repaid its premium advances. Given enough time prior to retirement, it may be possible to overfund a Universal Life insurance policy such that the cash value growth will be sufficient to maintain the policy’s death benefits even after withdrawing basis to repay the premium loans.

The income tax treatment of split dollar loans used for estate planning remains the same. With loan treatment, the executive does not have to pay taxes on the economic benefit associated with life insurance since the executive is treated as having paid for the insurance. Instead, the premium payments made by the organization are treated as a series of “below market” loans and the executive must pay income tax on the “imputed interest.” Section 7872 of the Internal Revenue Code provides that where employees are allowed to borrow money at below market interest rates, the amount of interest saved on the transaction should be considered an element of compensation to the employee.

Thus, for example, assume an employer advances $1,000 towards the purchase of life insurance for an executive where the executive pays no interest and the fair market interest rate is 5.0 percent. Since the executive saves $50 in interest costs, the IRS imputes $50 of income to the executive.

While the executive must pay taxes on imputed interest, the cash build-up in excess of the organization's interest in the policy grows tax-free. Death benefits coming from split dollar loan arrangements are also tax-free.

As is the case with non-equity collateral assignment split dollar arrangements, where split dollar loans are 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 is 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 plan types that may be appropriate for accomplishing specific client objectives.

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

Using these objectives as the starting point for discussion, you can help nonprofit and tax-exempt organizations design plans to help meet their goals for recruiting and retaining executives. Where the organization wants cost recovery and “Golden Handcuffs,” and the executive wants tax deferral, consider a § 457(f) plan. Where the organization wants cost recovery and the executive wants flexibility, consider split dollar loans. Where the organization wants “Golden Handcuffs” and the executive wants flexibility, consider using either a split dollar loan/§ 457(f) combo arrangement or a REBA. Where the parties want a simple arrangement that gives the executive maximum flexibility, consider an executive bonus arrangement. And finally, where the executive or director is primarily interested in estate planning, consider non-equity collateral assignment split dollar arrangements or split dollar loans.

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