# Loan Regime Split Dollar

*By Chris Burns-Fazzi and Kirk Sherman*

Not long ago, shouting "split dollar life insurance" was a sure way to empty a crowded room of credit union directors and executives. However, thanks to law clarifications, product enhancement, the current low interest environment, and administration improvements, loan regime split dollar is now attracting positive board and executive attention.

"Split dollar" refers to a broad array of arrangements where an employer and a key employee split the dollars in a life insurance policy. Since the IRS issued new regulations in 2003, the array has consolidated into two general regimes, one of which is the loan regime. The policy owner determines which regime applies. Loan regime applies when the executive owns the policy or when the executive and the credit union jointly own the policy and the executive is the first named owner.

In loan regime split dollar ("LRSD"):

- The credit union pays the premiums on the policy.
- The executive assigns the policy to the credit union as collateral for repaying the premiums.
- The executive borrows from the policy to supplement retirement income.
- The credit union is repaid from the policy's death proceeds.

Under LRSD tax rules, the credit union's premium payments are treated as loans to the executive. If the credit union charges and collects interest on the loan at the IRS-specified "applicable federal rate" ("AFR") or higher, the executive has no taxable income during life or at death. If the credit union does not charge and collect interest on the loan, or charges less than the AFR, the shortfall is taxable to the executive each year.

A simple comparison explains the LRSD resurgence. Consider two plans that provide retirement benefits of $50,000 a year for 20 years. One plan is the typical 457(f) nonqualified deferred compensation plan, and the other is LRSD:

| Characteristic | 457(f) Plan | LRSD |
|---|---|---|
| Income taxes | • Present value of full benefit taxed upon vesting | • None |
| Net after tax benefit | • $600,000 (assuming a combined 40% tax bracket) | • $1,000,000 |
| Creditor risk | • Executive is a general creditor of the credit union | • None |
| Financial reporting impact | • P&L hit each year as the benefit accrues | • P&L gain for loan interest<br>• Balance sheet receivable |
| Cost to credit union | • $1,000,000 | • None (full cost recovery) |
| Form 990 reporting (state-chartered credit unions) | • As deferred compensation as benefits accrue<br>• Then again as W-2 compensation when paid | • Balance sheet receivable in the core Form 990<br>• Loan details on Schedule L |

The LRSD transition from foe to friend results from:

- The IRS publishing clear tax rules
- Insurance policy enhancements
- Low interest rate environment
- Administration system enhancements

## Clear Tax Rules

Before 2003, the split dollar rules were a mess. Relying primarily on an IRS Revenue Ruling from 1964, and aided by thirty-plus years of IRS inattention, planners and employers became ever more creative in their designs, stretching the basic rules to (and to many, beyond) their breaking point.

An IRS technical advice memorandum in 1996 started the reform ball rolling, but it took seven years before the IRS published the final split dollar regulations in 2003.

The final regulations did two things, both of which have come to be viewed as acts of compassion. First, they grandfathered arrangements that predated the final regulations. Second, they brought the years of "freedom" in designing split dollar arrangements to a close by clearly defining the rules that would apply to split dollar going forward. They established high guard rails and clear direction signs along the path new arrangements must follow. Now more than ever the credit union can know with certainty whether any particular split dollar design is compliant.

One example of a clear new rule relates to the interest on the premiums the credit union pays. The regulations describe three options:

- Don't charge interest and instead have the executive report the interest in taxable income each year;
- Charge interest and have the executive pay the interest from after-tax income each year; or
- Charge interest, but accumulate the interest (compounded) until the executive's death and pay the interest out of the policy's death proceeds.

## Insurance Policy Enhancements

Many prior split dollar arrangements were variable products, where the policy's cash value floated with the value of the specific market funds the executive selected. That worked well when the market consistently returned 8 percent or more year after year. But then reality hit, and with it evaporated the values executives had accrued for years if not decades. Along with the values evaporated the perception of split dollar as an attractive planning device.

In response, many carriers have developed policies specifically designed for split dollar generally, and for LRSD specifically. The new features include:

- Equity indexing – Policy cash values are based on the annual change of a major market index (such as the S&P 500) instead of specific mutual funds.
- Risk-mitigating collar – A "collar" assures the cash value investment return will not be negative in down markets. The trade-off for the down-side protection is a limit on the upside in positive markets. For example, a "0 percent - 13 percent" collar would credit 0 percent in years the market returns 0 percent or less, 13 percent in years the market returns 13 percent or greater, and any number within this range if the annual index return is within that same range.

- Low or no surrender charges – The ability to exit the policy early without loss is particularly important if the arrangement has vesting requirements that may not be met in the early years and require policy surrenders. It also addresses safety and soundness (liquidity) concerns.
- No-lapse riders – Many bad things happen if the policy lapses: unrecovered loans, large tax liabilities, little or no retirement income, and unprotected survivors. Policy riders are now available to assure that the policy will not lapse.

## Low Interest Rate Environment

Thanks to current economic conditions, interest rates are the lowest seen in generations. The short-term AFR for November 2012 is 0.22%, and the long-term AFR is 2.4%.

Although low interest rates are not essential to LRSD, they do enhance the economics. The low interest rates reduce the reportable income if interest is reported in income rather than paid, and otherwise reduce the amount the executive must pay.

The question becomes which rate to use. By using a "demand loan" structure (the employer can demand repayment at any time), the AFR is based on the short-term AFR. The risk with the demand loan approach is the short-term AFR changes regularly. The advantages gained in low interest-rate years can dissipate quickly in high interest-rate years.

To eliminate the risk of rate variance, LRSD can be designed to lock in the long-term AFR at the rate in effect when the premiums are paid. To use the long-term rate, the credit union gives up the right to demand the loan at anytime, and instead commits to recovery only at the executive's death.

## Administration System Enhancements

LRSD is a long-term, relatively complex structure. If left to run on autopilot, the arrangement can jump the tracks with the devastating results described above. Many prior LRSD arrangements fell victim to administrative neglect.

Any credit union considering LRSD will require outside professional administration, especially as the arrangement enters the retirement income phase when the executive borrows to supplement retirement income. Over-borrowing is the death knell, yet no one is served by under-borrowing. Determining the correct level of borrowing requires significantly more than a simple "eye-balling" of values.

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Newly-developed administrative systems remove the administrative guesswork. Instead, using performance models and confidence interval analysis based on the confidence factor the credit union specifies, sophisticated administrators can set borrowing levels that maximize retirement income while protecting the credit union's recovery of principal and interest.

To assure lifetime quality administration, the credit union will need to consider the administrator's experience, systems and dedication to LRSD. Where the cost of administration is "rolled into" the initial plan implementation, the credit union can expect in later years to get what they are paying for. Instead, the credit union should expect that there will be an annual administration fee for LRSD, and should factor that cost when evaluating the plan. Such fees are a small price for protecting the credit union's recovery and the anticipated non-tax treatment for the executive.

With clear tax treatment under the IRS split dollar regulations, insurance product enhancements, the current interest rate environment and professional administration, LRSD, instead of clearing a room, can attract, retain and reward the industry's best management talent with little or no cost to the credit union. Expect to see more of it.

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