LOAN REGIME SPLIT-DOLLAR PLANS
FOR EXECUTIVES OF TAX-EXEMPT ORGANIZATIONS

SUMMARY

Loan Regime Split-dollar (LRSD) Plans are a popular alternative to 457(f) plans, offering substantial death benefit protection to key executives and favorable access to policy cash surrender values for emergencies or to supplement retirement income.

This Summary provides a high level review of M Financial's three-article series: (1) Basic Plan Design, (2) Loan Interest, and (3) Waiver-Loan Programs. Please see those articles for an in-depth treatment of LRSD Plans.

PART 1 — BASIC PLAN DESIGN

With the LRSD Plan, the nonprofit lends funds to the executive to purchase two personally-owned life insurance policies as follows:

1. The "benefits policy" provides death benefit protection and favorable access to cash values.
2. The "repayment policy" repays the loans to the nonprofit regardless of when the executive dies.
3. Each policy is designed as a minimum non-MEC death benefit accumulation variable universal life (VUL) policy to maximize benefits to the executive, ensure tax-free access to policy cash values, and ensure repayment of the loans to the nonprofit.
4. Each premium payment is a separate lifetime term loan (a "hybrid" loan) from the nonprofit to the executive accruing sufficient interest at the appropriate Applicable Federal Rate (AFR).
5. The loan plus accrued interest is repaid from the combined death benefits of the policies.

Code Sec. 409A, effective January 1, 2005, requires that a written plan determine when an executive can defer compensation, the timing and form of benefit payments, when those payments may be accelerated or changed, and when an employer may terminate a plan. Violation of 409A subjects the executive to taxation on current and past deferred compensation, interest charged at the underpayment rate plus 1%, plus a penalty equal to 20% of deferred compensation amounts.

Notice 2007-34, issued contemporaneously with the 409A final regulations (April 10 and 17, 2007 respectively), provides that split-dollar loans generally will not give rise to 409A deferrals of compensation unless, *"for example, ... amounts on a split-dollar loan are waived, cancelled, or forgiven."*

Therefore, an LRSD Plan comprised of bona fide loans as described above is not subject to 457(f), does not create income subject to the 21% penalty of Code Sec. 4960, and, most importantly, does not violate Code Sec. 409A.

> **The LRSD Plan should be carefully documented and administered, including annual policy reviews, to ensure that the plan is on track.**

Adjustments should be made as needed to ensure that the nonprofit is fully secured by the policy death benefit under then current and reasonable assumptions.

PART 2 — PROVIDING FOR LOAN INTEREST

With every LRSD Plan, it is critical that, pursuant to the split-dollar loan regulations, sufficient loan interest is paid or accrued in all plan years. There are four options for handling loan interest:

1. Pay interest out-of-pocket, optionally for a limited duration with accrual thereafter.
2. Accrue loan interest in all years.
3. Bonus or double bonus loan interest while employed, and accrue thereafter.
4. As an alternative to #3, the executive forgoes the bonus and increases the loan by the forgone payments. Frequently, this will provide a greater benefit to the executive and to the nonprofit since it will recoup the additional loans plus interest.

Many LRSD Plans promote loan interest forgiveness. Some of these designs are extremely aggressive:

1. Whether forgiven or bonused for a period of employment and/or post-employment, a plan that provides fully vested (that is, guaranteed) forgiveness of, or bonusing of, loan interest at inception is immediately taxable as deferred compensation since it is not subject to a substantial risk of forfeiture.
2. Post-employment forgiveness of loan interest is only allowed for a few years if subject to an enforceable and compliant noncompete agreement. Otherwise, it is problematic at best, and, at worst, it could create onerous tax consequences for the executive and the nonprofit.

On the other hand, forgiveness of loan interest contingent on the executive's employment at the time it is due and forgiven would be subject to a substantial risk of forfeiture and should qualify as a "short-term deferral." Short-term deferrals are outside the reach of 409A and its penalties and 457(f). That is, it is not taxable until the year forgiven.

When a bonus or forgiveness program is considered, frequently, amortizing amounts of expected loan forgiveness or bonuses into premium payments is more advantageous to the executive and the nonprofit and avoids the financial and practical concerns with forgiveness of, or bonusing of, loan interest.

PART 3 — WAIVER-LOAN PROGRAMS

Part 3 discusses two important strategies: (1) waiving the right to a 457(f) plan balance and concurrently implementing an LRSD Plan (Waiver-Loan programs) and/or (2) waiving the right to current compensation and concurrently implementing an LRSD Plan (Compensation-Waiver programs). Because the LRSD loan is not waived or forgiven, nor is it secured by or repaid from the waived 457(f) balance, it is our opinion that these programs do not trigger current taxation. However, caution is advised because they have not been ruled on by the Service or tested in the courts.

WAIVER-LOAN PROGRAMS

In a Waiver-Loan program

1. An executive waives his unvested 457(f) plan benefit.
2. The executive and the nonprofit enter into an LRSD Plan.

Notice 2007-34 provides that split-dollar loans generally will not give rise to 409A deferrals of compensation unless, *"for example, ... amounts on a split-dollar loan are waived, cancelled, or forgiven."* Two of 409A regulation's sections must also be reviewed: Reg. Secs. 1.409A-3(f) provides:

> *A forfeiture or voluntary relinquishment of an amount of deferred compensation will not be treated as a payment of the compensation, but there is no forfeiture or voluntary relinquishment for this purpose if an amount is paid, or a legally binding right to a payment is created, that acts as a substitute for the forfeited or voluntarily relinquished amount.*

"the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred compensation"

Reg. Sec. 1.409A-2(b)(2)(i), further describes a taxable payment:

"a payment includes, but is not limited to, the transfer, cancellation, or reduction of an amount of deferred compensation in exchange for benefits under a welfare benefit plan, a fringe benefit excludible under section 119 or section 132, ***or any other benefit that is excludible from gross income****."* [Emphasis added]

It is our belief that neither regulation section applies.

It is a well-established principle of the Tax Code that income is not recognized (and taxed) until something of value is exchanged or received including the forgiveness of a debt.

This principle is operative with the 457(f) plan itself where benefits are not taxed until the substantial risk of forfeiture is removed — typically, when the executive vests in plan benefits after which time payment is guaranteed.

Taxing a Waiver-Loan Program where neither the 457(f) plan nor the split-dollar loan has value would violate this well-established tax principle and is likely not what Congress intended. First, since a 457(f) plan provides an unfunded, unsecured, and non-vested promise to pay that is subject to a substantial risk of forfeiture, the 457(f) plan has no value until vested. Second, a split-dollar loan has no intrinsic value because, in accordance with the split-dollar loan regulations, the loan charges sufficient interest. That is, the executive is paying full value for what is received. This position is supported by Notice 2007-34 where the waiver could only create value if it resulted in the actual current repayment of the loan or the legally binding forgiveness of it in the future.

COMPENSATION-WAIVER PROGRAMS

In another design alternative, an executive, who is one of the top five highest compensated officers, waives future compensation in excess of $1 million and the nonprofit lends funds to the executive as a split-dollar loan (Compensation-Waiver Program). This is attractive to the nonprofit because (1) it will avoid the 21% penalty on compensation in excess of $1 million and (2) the loan will be repaid in full in an amount equal to the loan plus unpaid and accrued interest.

Although it might look like an executive is deferring compensation with the Compensation-Waiver program, this, in fact, is not the case. The rationale discussed above with respect to Waiver-Loan Programs applies equally to waiving compensation. Future compensation has no value until it's earned and the relinquishment of it before it's earned has no value. Likewise, the split-dollar loan has no intrinsic value because, in accordance with the split-dollar loan regulations, the executive is paying full value for what he receives. Therefore, the executive is waiving compensation that has no current value in exchange for a split-dollar loan that has no intrinsic value.

AN INFORMED DECISION

Again, caution is advised because the Service has not ruled on these programs, and they haven't been tested in the courts.

It is up to the clients, based on the advice of legal and tax counsel, to make the call whether to implement an LRSD Plan, a Waiver-Loan Program, or a Compensation-Waiver LRSD Plan.

It is highly recommended that the executive and the nonprofit each engage their own independent legal and tax counsel with expertise in executive benefit plans for nonprofits to ensure that both parties understand the risks and can make an informed decision.

This piece was created by M Financial's Advanced Planning experts and produced by the marketing team.

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