# Using Split-Dollar with Tax-Exempt Entities

Non-profit employers often find themselves having to compete with for-profit employers to hire and retain executive talent. Those non-profit organizations have to pay their employees enough compensation to ensure that they aren't poached by the for-profit competitor up the street, but the non-profit's ability to truly compete is hindered by a couple of factors that the for-profit employer doesn't have to worry about.

First, the annual requirement that a non-profit file a public accounting of all compensation paid to employees has an impact. A non-profit employer's worst nightmare is having the local newspaper pick up the annual compensation report on a slow news day and lay out employees' compensation information for all to scrutinize. Second, a non-profit's ability to pay an executive retirement compensation is impacted by § 475(f)'s requirement that all compensation be taken into income in the year that the employee stops working for the non-profit. This triggers a big income tax hit to the executive and is a huge number to put onto the annual compensation report.

Non-profit employers were struggling with this before the 2017 Tax Cuts and Jobs Act rubbed salt in the wound by creating an excise tax on "Excess Tax-Exempt Organization Executive Compensation."

## WHAT IS THE EXCISE TAX?

The excise tax imposes a 21 percent penalty on a non-profit entity for the remuneration paid by tax-exempt employers – including public universities, political organizations and farmers' cooperatives – in two situations:

- Amounts in excess of $1 million paid to a covered employee for a tax year.
- A separation (parachute) payment equal to or greater than three times the final five-year average of their annual earnings paid to a highly compensated employee. (In 2019, employees making more than $125,000 are defined as "highly compensated.")

## WHAT IS LOAN REGIME SPLIT-DOLLAR?

What if there were a solution that helped non-profit employers with all of their compensation woes, including the excise tax? Loan regime split-dollar is just such a solution.

Imagine a non-profit using a typical split-dollar loan agreement for their top executive. The employer pays the life insurance premiums on behalf of their executive (the policy owner) through a series of premium loans. These loans are interest bearing and are repaid from either the cash value or death benefit of the policy.

By switching to a series of premium loans, the non-profit employer is able to offer the executive a larger potential retirement benefit through the leverage inherent in a life insurance policy. In addition, the executive's income tax burden is reduced because she can access the policy's cash value income tax-free, by first withdrawing the basis in the contract and then switching to policy loans. In fact, the only potential income taxes the executive will have to pay would be associated with taking the loan interest into income.

Loan regime split-dollar allows the non-profit to offer its executives compensation that matches that paid by for-profit employers. Also, because the arrangement is a loan, it's not reported on the annual statement as compensation, and it's not subject to the rules of § 457(f) or the excise tax. By implementing loan regime split-dollar, the non-profit is able to address its three most pressing concerns surrounding employee compensation.

Ultimately, because this is a loan arrangement, the executive is responsible for repaying all amounts borrowed from the employer. This repayment usually comes from the cash value or death benefit of the policy — providing cost recovery to the non-profit as well.

**By implementing a loan regime split-dollar arrangement, the non-profit employer is able to provide its executives with a more meaningful retirement benefit, reduce the optics problem from annual compensation reporting, mitigate the excise tax and recoup monies loaned out to provide the retirement benefit.**

## THE BOTTOM LINE

By implementing a loan regime split-dollar arrangement, the non-profit employer is able to provide its executives with a more meaningful retirement benefit, reduce the optics problem caused by the annual reporting of all compensation paid, mitigate the impact of the excise tax and recoup monies loaned out to provide the retirement benefit, making loan regime split-dollar a compensation strategy unlike any other.

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