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Collateral Assignment

Split Dollar Life Insurance Plan Considerations

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Executive compensation and benefits are at the forefront of strategic issues facing the credit union industry.

The demand for strong leadership, shortage of executive talent, limitations on qualified plan contributions, and need to compete with for-profit banks has elevated the number of credit unions looking to long term compensation strategies to fill the gap. When exploring options, credit unions discover a crowded marketplace of design and investment options from a host of vendors, many of which promise a proprietary, complete, foolproof solution. In too many cases, a credit union is presented the potential positives of a strategy but not the potential risks.

The purpose of this paper is to explore the potential pitfalls that a credit union should understand before implementing a Collateral Assignment Split Dollar (CASD) strategy. D. Hilton has long believed that an effective retention and retirement strategy is one that is fully understood by the client and it is our goal that this commentary will assist credit unions in making an informed decision.

What is a Split Dollar Plan?

The importance of executive compensation and benefits is greater today than it has ever been in the credit union industry. As credit unions look to recruit executive managers, they are finding a marketplace short of qualified talent and the presence of robust compensation plans that handcuff those executives from considering other opportunities. These handcuffs come most commonly in the form of a Supplemental Executive Retention and Retirement (SERP), which is a plan that establishes a benefit for the executive to be provided at a future date in exchange for the executive's employment. These plans are extremely useful for covering qualified retirement plan shortfalls imposed by IRS compensation limits set on senior executives (415 Limits). These plans also serve as a terrific way of competing with bank compensation plans where equity options are common.

When designing a SERP Plan, one has several different designs that can be considered, the most commonly used being a 457(f) SERP Plan. D. Hilton's SERP Survey continues to find that a large majority of credit unions prefer this design. However, there are alternative plan designs one could consider, two of which are an Endorsement Split Dollar Plan or a Collateral Assignment Split Dollar Plan.

Many credit union Boards mistakenly believe that split dollar life insurance is a "product," when in reality it is simply a "design." There are two types of split dollar life insurance plans a credit union can use: "endorsement" and "collateral assignment". Both products simply use life insurance to generate tax deferred cash values.

What are the Different Types of Split Dollar Plans?

In both designs, the executive goes through underwriting for a life insurance policy. The amount of insurance provided and the net cost of insurance would depend on the health and age of the executive, income caps on the amount of coverage allowed, and any other suitability criteria measured by the carrier. **The notable difference between "endorsement" and "collateral assignment" is ownership of the policy.**

In an Endorsement Split Dollar (ESD) agreement, the credit union owns the insurance policy. Any value gained when the policy is endorsed to the executive is treated as ordinary taxable income.

In a Collateral Assignment Split Dollar (CASD) plan, the executive owns the policy, not the credit union. Therefore, the executive has the authority over the policy once it is in place. To pay the premiums on the policy, the credit union makes a one-time loan to the executive for the total cost of the premiums on the life insurance plan. This loan to the executive will be charged interest at the current long-term Applicable Federal Rate (AFR). The policy loan and interest will compound until the loan is repaid by the executive. Loan repayment is often tied to the death of the executive and/or a spouse.

What are the Considerations Associated with a Collateral Assignment Split Dollar Plan?

To protect the credit union's investment, the executive collateralizes the life insurance policy to the credit union. In many cases, two policies will be created. One to protect the credit union's investment via death benefit and one to accumulate cash values for the executive. Upon retirement, the executive would take policy loans from the cash account. Those loans in retirement could incur interest that will deplete the policy cash value.

While Endorsement Split Dollar Plans carry many qualities found in 457(f) SERP plan designs, Collateral Assignment Split Dollar Plans differ substantially and the following are some of the many factors a Board and/or CEO should consider before executing a Collateral Assignment Split Dollar Plan.

Taxation Risks to Executives

Some believe that a Collateral Assignment Split Dollar plan falls outside of 457(f) and 409A regulations and by doing so, the policy loans taken by the executive would be free of taxation. However, because these plans are deferred compensation to the executive, some view these plans as an interpretation loophole of IRS law. Since credit unions are tax exempt, an executive might discover in retirement that these plans indeed are considered deferred compensation under 457(f) and 409A, and therefore are taxable. In addition to taxing the benefit, the IRS also has the authority to impose a 20% penalty for lack of compliance plus interest on the taxes. **To ensure the plan provides a tax free benefit, the credit union should request the split dollar provider to provide a certified legal opinion from a qualified benefits attorney, insurance carrier, or the IRS to protect itself from liability.**

Legal Risks to the Credit Union

While the credit union does not risk taxation from the IRS, if it should be determined that these plans are taxable, it is possible that the executive would then hold the credit union liable for the additional deferred compensation promised. For example, if the executive was promised a tax free benefit of 60% of final average compensation and the IRS assessed taxes at a 40% income tax rate plus a 20% penalty, the executive's true benefit is significantly lower than the 60% commitment. To protect the credit union from future legal liability, the credit union should request a split dollar provider to provide a certified legal opinion from a qualified benefits attorney, insurance carrier, or the IRS to protect itself from liability. The agreement should also state that any and all tax liability is with the executive, not the credit union.

Limited Insurance Carrier Options

Many insurance carriers will not honor a credit union's Collateral Assignment Split Dollar arrangement using their life insurance policy because of the legal liability they feel these plans carry. Because the life insurance policy and a split dollar insurance arrangement are two distinct events, the credit union should be certain the carrier is aware of the intention to deem the policy collateral assignment, otherwise the credit union and executive could risk forfeiture of the policy.

Underfunding & Underperformance

Collateral Assignment Split Dollar plan investment yields are typically tied to the insurance company's "general account", which is used to cover the insurance company's obligations. Law requires the "general account" to invest in conservative fixed income investments such as treasuries and corporate bonds.

Insurance agents typically present hypothetical scenarios that include a guaranteed crediting rate and then multiple forecasting rates that could be considered unrealistically aggressive. These forecasting rates are not guaranteed and are before the cost of the insurance policy.

Underfunding and underperformance can cause a number of potential issues:

Underfunded Benefit

A peer competitive deferred compensation plan is one that provides a defined benefit of 60% to 80% of final average total compensation to the executive. Because the performance of the insurance is often times tied to conservative fixed income investments, the credit union's plan could be significantly underfunded as the executive approaches retirement. In this instance, the credit union could be required to pay the executive a one-time benefit to make up for the investment shortfall at the time of retirement. That payment would not have had the benefit from accrued interest over the life of the executive's employment. In addition, that one-time payment would be taxable to the executive, meaning a much larger payment would be needed than the original pretax scenarios run in the collateral assignment split dollar actuarial tables. This one-time benefit expense could be required regardless of the credit union's financial situation at the time of payment or Board opinion and could be under large scrutiny by members, employees, etc.

Forgiven loan trigger issues

While the credit union might be tempted to forgive, waive, or cancel a portion of the executive's repayment of those premiums in an attempt to fill the gap of underfunding (as opposed to writing a check to the executive for the underfunding), this could trigger 409A since the Collateral Assignment Split Dollar plan would no longer be treated as a "loan regime" and the executive could be exposed to tax liability, a 20% penalty, plus interest.

Loan regime test

An additional concern could be the potential for regulators or the IRS to determine that the Collateral Assignment Split Dollar plan might fail the "loan regime" test, and therefore be qualified for 409A and 457(f) as a defined benefit plan. For a Collateral Assignment Split Dollar plan to be qualified as a "loan regime," the IRS requires that "a reasonable person would expect that the premiums will be repaid in full." This would be similar to the credit union loaning someone $100,000 on a $20,000 automobile (the insurance cash values are not near what was expected).

Economic benefit regime

Because the executive does not have personal liability for the premium payments and can walk away from the policy at any time, if the cash value and death benefit are not enough to satisfy the premiums paid, the IRS could determine that the Collateral Assignment Split Dollar plan is not a collateral loan regime, but instead it should be classified as an economic benefit regime. That would mean the premiums paid would be treated as compensation to the executive triggering 457(f) and 409A. This would immediately expose the executive to current tax on all vested benefits (premiums), as well as possible 409A penalties of 20% plus interest on those penalties.

Lack of Credit Union Control

In a 457(f) SERP, the Board controls the deferred compensation program. This is not the case in a Collateral Assignment Split Dollar plan. The executive owns the collateral assignment split dollar policy. The executive assigns the policy to the credit union as collateral on the loan, but the policy is still owned by the executive.

This causes a number of potential issues:

No "Handcuff"

Because the executive can walk away from the policy at any time, all of the risk rests on the credit union. This does not provide the proper "handcuff" needed to retain the executive. Should the executive decide to move to another employer, the executive can immediately repay the credit union the premiums and interest accumulated on their plan and move to another employer with the policy. For example, if the credit union had invested $100,000 in premiums, the executive could simply negotiate a $100,000 loan with another employer as part of their acceptance offer, pay their past employer the premiums owed, and walk away with the policy.

Walkaway

The executive can leave ("for cause" or "not for cause") and refuse to pay back the premiums. In this case, the cash value and death benefit may not be enough to cover the premiums paid. If premiums cease, the credit union could lose its initial investment. The limited options available to the credit union would be to: Surrender the policy, possibly at a loss depending on the surrender period; Continue paying premiums and recoup the cash value at some time in the future and/or; Wait for the executive to die and collect the death benefit (the life expectancy of a 50-year-old male is 85).

Death Benefit Issues

Because of the conservative nature of the insurance investments, many Collateral Assignment Split Dollar plans cannot return the credit union's initial investment until the executive and the executive's spouse are deceased (using the death benefit). This means there is no seed money for a deferred compensation plan to hire the next credit union executive, nor does the credit union recoup its initial investment for a long period of time (20 to 30 years after the executive's retirement).

Loan Interest Deferral Issues

Assuming the credit union will not receive repayment for the insurance premiums until the executive's death, this would mean the credit union would have premium loans to the executive for 20, 30, or maybe 40 years. If most executives retire at 65 and mortality is currently at age 85, 15 years from now the mortality age could be much higher. This means the credit union's initial investment principal and interest earned would not be recouped for 20 or 25 years from the executive's retirement. This is money that would be tied up and unavailable to be used to fund the next executive's benefit or for distribution to the membership in the form of consumer loans.

Outstanding Loan Issues

Many credit unions do not wish to carry an insurance policy on an executive for years after the executive leaves, nor do they wish to have outstanding loans for such a period.

Loan Call Risk to Executive

Under a Collateral Assignment Split Dollar plan, the policy premium loan has the potential to be called by the credit union at any time. This could be a scenario if the CEO and the Board become at odds, or if the marketplace in which the credit union competes changes. Interest rates could rise, and the Board may decide that the AFR rate they are making on their money is not enough to justify what could be made on consumer loans in the marketplace. The executive also runs the risk that the Board composition may change and decide that they want out of the policy.

Reputation Risk Issues

Most credit unions do not offer members the ability to take policy loans for the purchase of a Collateral Assignment Split Dollar life insurance policy. Because the credit union is making a loan commitment far from what would be permitted to a member, the credit union has a reputation risk for favoring executives over member-owners. Given the backlash concerning U.S. corporations using inversion strategies to avoid U.S. taxes, the credit union also risks the perception of aiding executives in avoiding income taxes.

Plan Costs to Unravel

If the executive and credit union become at odds early into the plan and it is decided to cancel the contract, any surrender charges on the policy and attorney's fees could be the ultimate responsibility of the credit union, not the executive. However, if the employer decided to call the loan premiums or decided to stop paying premiums, the cost of getting out of the policy could be significant to the executive.

Depletion of Interest Earning Principal

When implementing a Collateral Assignment Split Dollar plan, the credit union loans the executive the premium payments, and those premium loans are charged at the current AFR rate. That loan interest will compound over the life of the executive's employment, and typically through the death of the executive. If the credit union wishes to receive its premium loans at retirement, the credit union would then receive the loan premiums and interest from the cash account, significantly depleting the cash values needed to fund the executive's benefit.

Then during retirement, the executive must also take policy loans against the cash account, providing further depletion of the cash value (the executive can only take loans against the cash account; not the death benefit). Those tax free policy loans are loans provided by the insurance company, and the executive must have to pay interest to the insurance company on all borrowings. Therefore, the executive is not borrowing from themselves.

The interest rate charged would be determined at the time the loans are taken. If rates were to rise at the time the executive starts taking loans, the insurance company has full authority as to the interest charged on those loans. Since the executive plans to live off those loans, the interest will be paid yearly by the executive or from the cash account, therefore further dwindling the compounding earned during retirement. Because it is difficult to say what that rate might be, an executive could find their policy severely underfunded after the fact.

Insurance Agent Commissions

Many insurance agents take large front loaded commission structures that present a conflict of interest. Once the policy is effective, the agent's fiduciary responsibility for the ongoing maintenance of the plan may be at risk. It is important for the credit union to clearly understand the costs of the plan and the commission structure in place for the agent.

Limited Insurance Carrier Dollar Amounts

Any insurance company that does issue Collateral Assignment Split Dollar plans may have limitations in the amount of insurance they can offer due to the size of the benefit needed. For example, a conservative insurance carrier may be willing to write a policy with premiums that are 10 to 20 times the executive's annual income. Therefore, when examining the total benefit for a credit union executive, it can be difficult to find a single carrier willing to take on that much insurance for one executive.

Insurability of the Executive

The design and success of a Collateral Assignment Split Dollar plan is based on an executive-owned life insurance policy. The executive must go through underwriting for such a policy. Any assumptions made in the design phase are irrelevant until the insurance company has assessed the executive.

For example, one could design a plan that provides a $1 million death benefit for a total of $500k in premiums. An agreement could be drafted and signed only to subsequently realize that the best policy that could be obtained for the executive is a $500k death benefit for premiums of $1 million. The credit union cannot forecast the investment needed to make the executive whole until underwriting is accomplished. Because of underwriting, Board members are unable to know the initial investment outlay at the design phase and will not know until underwriting is completed. In addition, the insurance company might not be able to provide enough insurance coverage to satisfy the defined benefit gap the credit union wishes to fill.

Balance Sheet Impact

Because a peer competitive SERP typically entails a guaranteed minimum benefit, the credit union may be required to account for the deferred benefit expense even though the credit union earns no immediate income from the plan.

Lack of Product Diversification

Collateral Assignment Split Dollar insurance plans typically utilize one insurance carrier and one product. Not only does it bring potential carrier risk, but the investment typically relies solely on the general account performance of that single carrier.

Transferability of the Plan

Because the plan is designed around a single executive, transferability to another executive is difficult and costly. The new executive must go through underwriting and the terms of the insurance policy may be subject to change or cancelation.

Time to Recovery

Because of the large amount needed to fund the executive's benefit, in many cases the credit union must wait until the executive's death to recover the investment (e.g., for a 55 year old that could be at age 85 or greater). In addition, the cash surrender value of these plans is typically not greater than the premiums paid for the first 8 to 10 years.

Interim Distributions

More than half of all deferred compensation plans provide multiple distributions throughout the life of the plan. However, multiple distributions are more challenging to design and accumulate sufficient cash values when using a Collateral Assignment Split Dollar plan.

Fair & Reasonable

The tax advantages of an executive-owned loan regime Collateral Assignment Split Dollar plan may be appealing to the executive. However, the benefit to the credit union is less clear and not easily calculated. Typically, a credit union benchmarks what is fair and reasonable compensation in the credit union industry. D. Hilton research indicates that targeting 70% to 80% of the last five years' average total compensation is competitive for a President/CEO at a credit union with $1 billion or more in assets. This percentage is calculated pre-tax and is typically offset by projected Social Security and employer contributions to any other qualified plans (e.g., 401(k), 403(b), etc.).

As an example, assume that when calculating a retirement benefit targeting a 70% before tax benefit of the executive's last five years average total compensation, one arrives at a projected one-time payment to the executive of $10 million. If we were to assume a 40% tax rate on the payment, the executive would net $6 million after taxes.

Now consider a collateral assignment split dollar approach. If we target a $10 million one-time payment to the executive and assume no taxation on the benefit, the executive is now realizing a pretax benefit of more than $16 million. The original 70% benefit established by the Board of Directors is now 110% of the executive's last five years' average total compensation, far exceeding fair and reasonable for the credit union industry. Therefore, it is difficult to compare plans using a benefit dollar amount because taxation can play heavily on reasonability.

Conclusion

D. Hilton has the privilege of designing and administering customized compensation strategies for more than 900 credit unions. We have found that just as each credit union is unique, the retention and retirement strategy employed for its executives should be as well. If you have questions or wish to discuss our services further, do not hesitate to call us at (800) 367-0433 or visit our website at www.dhilton.com.