Structuring the Loan in Loan Regime Split Dollar

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Loan regime split dollar (LRSD) is becoming a staple in credit union executive compensation packages. Over the last 15 months, the number of credit unions using LRSD has grown by 40%.[1] Twenty new credit unions added LRSD each quarter. Boards like LRSD because of its favored tax treatment for the executive and cost recovery for the credit union.

LRSD designs vary widely. They—

- Use different insurance products.
- Vary the timing of the credit union's deposits into the policy.
- Impose a wide spectrum of vesting and forfeiture requirements.
- Allow access to the funds in the policy at different times.
- Divide the death proceeds in different ways.

Notwithstanding these variations, all LRSD designs have two things in common. First, the credit union pays funds into a life insurance policy and is repaid those funds at a later date. This creates the "loan" element for which the arrangement is named.[2] Second, all credit union loans accrue interest. The executive must either pay the interest or report it in income.[3] If payments are required, interest can be paid annually or can be accrued and compounded and paid from the policy death proceeds.

LRSD loans can be structured as demand loans or term loans, and they can be recourse or nonrecourse. The loan structure selected will largely determine whether the arrangement succeeds or fails.

Demand vs. Term

A critical determiner of the success of LRSD is the interest rate charged on the credit union's loans. The lower the interest rate, the more efficiently the arrangement operates. The choices between a demand loan and a term loan, and if a term loan the length of the term, determine the minimum interest rate.

A simple test separates demand loans from term loans. According to IRS regulations, a demand loan is "any split-dollar loan that is payable in full at any time on the demand of the lender."[4] All other loans are term loans.[5]

> **Caution:** Some designs claim demand loan status without an actual demand right. Typically in these arrangements the executive signs a promissory note saying it is a demand note, but in the split dollar agreement signed at the same time the credit union agrees not to exercise the demand right.[6] Taken together, the documents do not create a loan that is "payable in full at any time on the demand of the lender." The IRS looks at the substance of arrangements in totality, and is unlikely to conclude that a loan that cannot be demanded is a demand loan.[7]

Term loans are divided into three categories depending on the length of the term of the loan:

Length of Term – Years	Category
Not over 3	Short-term
Over 3 but not over 9	Mid-term
Over 9	Long-term

Term Loans Without Terms. Some term loans do not state specific dates for repayment, but rather require the loan to be repaid upon specified events. Tax regulations assign a term to these arrangements. For example:

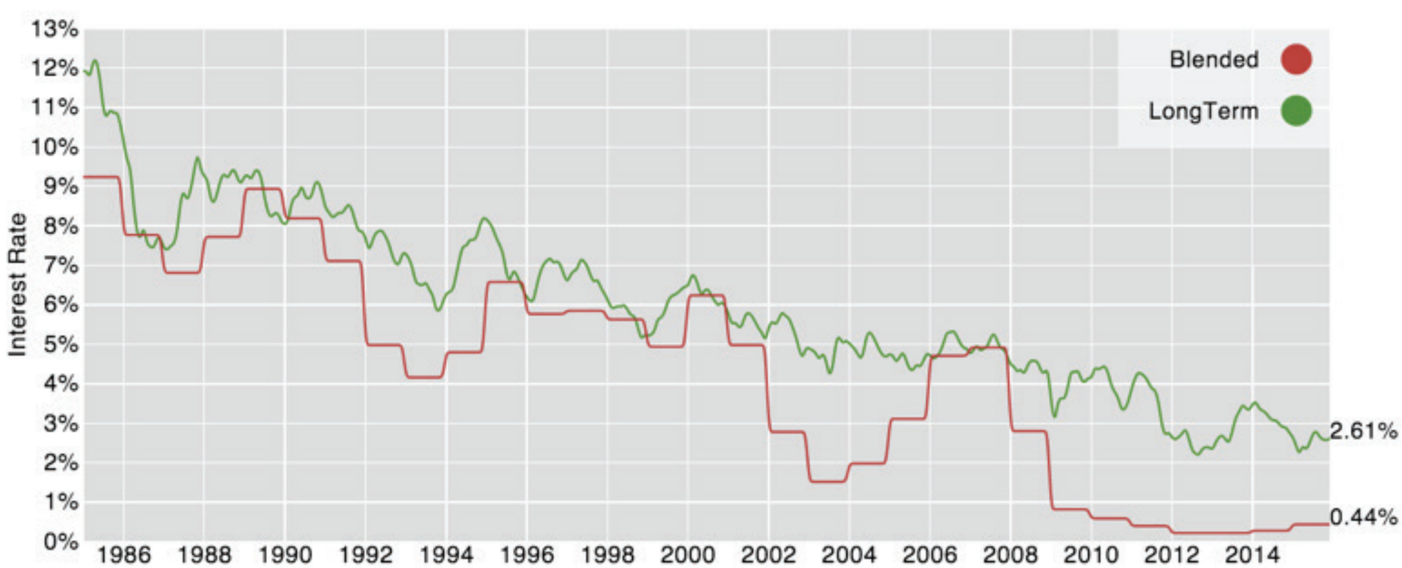
Repayment Event	Deemed Term
Termination of employment	7 years
Death	Life expectancy

Having selected either a demand or a term loan, the minimum interest that must accrue on the credit union's loan is the IRS-published "applicable federal rate" (AFR) for the type of loan:

Type of Loan	AFR
Demand	Blended Annual Rate (BAR)
Short-term	Short-term AFR
Mid-term	Mid-term AFR
Long-term	Long-term AFR

The IRS sets new short-term, mid-term and long-term AFRs each month, and sets the BAR mid-year.[8] For term loans, the AFR for the month in which the loan is made applies for the duration of the loan. If a term loan is renewed at the end of the stated term, the AFR resets to the rate in effect for the month of renewal. For demand loans, the BAR changes each year the loan is outstanding as the IRS annually sets the new BAR.

Since first published in 1985, the BAR and AFRs have varied widely.[9] For example, the BAR and long-term AFR histories are as follows:



The historically low BAR has led some credit unions to use demand loans. This minimizes current taxable interest income or interest accruals, minimizing the dollars that are diverted from the LRSD so it produces more supplemental retirement income for the executive and more death proceeds to divide between the credit union and the executive's beneficiary. This appears attractive for both parties.

However, selecting the variable BAR for an arrangement that can be in effect for 30 or 40 years could be shortsighted. The current long-term AFR is lower than what the BAR has been in 22 of the AFR's 31-year history. If history repeats itself, locking in the current long-term AFR may prove to be more efficient.

Beyond interest rate considerations, the executive is significantly more secure and likely to have access to the LRSD values with a term loan than with a demand loan. Under most LRSD designs, the credit union does not recover its premium loans (and interest, if accrued) until the executive's death. The board members who knew the executive and wanted to provide the retirement income to reward excellent service may have long since been replaced. The executive may be known only as a large receivable on the credit union's books. If finances for the credit union become difficult, or a new executive team is fighting to meet performance objectives to secure their own incentive payments, little may stop the credit union from calling the loan.

A pre-death call could significantly harm the executive's finances. Not only would the executive lose a source of retirement income, but the executive's personal assets would also be at risk. If policy values are inadequate, the executive may be required to repay any principal and interest the credit union cannot recover from the policy (see recourse loan discussion, below). The executive would also be taxed on any retirement income previously received under the arrangement and on any values the credit union cannot recover from the policy (if the arrangement is nonrecourse).

The relative advantages of demand and term loans can be summarized as follows:

Demand Loans	Term Loans
Historically low current interest rates	Historically low current interest rates
Credit union can call the loan if need arises	No interest rate risk
	Known interest rate allows more certainty in planning and design
	Executive is not at risk of loan being called

Recourse vs. Nonrecourse

The impact of the choice between recourse and nonrecourse LRSD loans may be less obvious than the demand versus term loan choice, but the consequences can be just as impactful on the financial interests of the credit union and the executive. The impact is in the allocation of underperformance risks between the credit union and the executive, and in the credit union's accounting for the arrangement.

The recourse/nonrecourse choice is an "end-game choice"—its primary impact only arises when the LRSD ends prematurely and the parties settle up, and then only if the dollars to be divided are less than the principal and interest on the credit union's loans. If the loan is recourse, the executive must pay the shortfall to the credit union. If the loan is nonrecourse, the credit union bears the loss, but the executive must report the shortfall in taxable income.

The recourse/nonrecourse choice's secondary impact is in the accounting for LRSD. Under GAAP, when the credit union records an asset (receivable) for its premium payment, it must write the value down to the value of the collateral for the loan.[10] If the loan is nonrecourse, the collateral for the loan is solely the policy's cash surrender value. Unless the policy is purchased with early cash value riders, the cash surrender value in early years can be significantly less than the premiums paid. In that case, the loan is written down on the credit union's balance sheet. The write down shows up on the profit and loss statement as a miscellaneous operating expense.

To avoid this write down, some LRSD arrangements require recourse loans. With a recourse loan, the credit union can count the value of the executive's recourse guarantee to minimize or eliminate the write down. GAAP allows counting the guarantee to the extent the credit union has determined the executive has the resources to make good on the guarantee, and the credit union actually intends to seek recovery under the guarantee if the need arises.

One additional consequence of the recourse/nonrecourse choice is in implementing the plan. If the loan is nonrecourse, then to avoid the executive having to report the projected interest value of the loan in income in the year the loan is made, the credit union and the executive must sign and file a written statement with their Federal income tax returns[11] for each year a premium is paid. The written statement represents "that a reasonable person would expect that all payments under the loan will be made."[12]

In weighing these three consequences of the recourse/nonrecourse choice, credit unions often consider that the main purpose of the arrangement is to reward long service. Conditioning the size of the supplemental retirement income on how the policy performs seems consistent with that purpose and with many deferred compensation plans. Putting not only the benefit but also the executive's personal assets at risk of the policy's underperformance seems a mixed message at best—"Here's a nice benefit, but if it doesn't work you have to pay us lots of money." This leads most credit unions to take the nonrecourse approach.

The impact of recourse and nonrecourse loans can be summarized as follows:

Recourse Loans	Nonrecourse Loans
Financial risk for the executive (having to pay shortfall)	Limited financial risk for the executive (having to pay taxes on any credit union recovery shortfall)
Financial security for the credit union	Financial risk for the credit union (may be mitigated by cash value rider)
Minimizes or eliminates the credit union's negative accounting impact	Negative accounting impact (reduced by cash value rider)
Written representation not required to be filed	Written representation required to be filed

Combinations

The demand/term and recourse/nonrecourse options create four possible combinations for LRSD loans. Many executives would rank the combinations from best to worst as follows:

Best Term/Nonrecourse
Term/Recourse
Demand/Nonrecourse
Worst Demand/Recourse

By one measure, the credit union's perspective would be the inverse. However, part of the calculus in any such arrangement is arriving at a balance where the costs to the credit union are equal to or less than the benefits. Having a satisfied executive (within the bounds of fair and reasonable compensation) can be a huge intangible benefit for the credit union. Another benefit is the prospect of recovering dollars that, if paid to the executive under a supplemental retirement income plan, would have been unrecovered expenses. Many credit unions are finding that this cost recovery more than offsets the effects of committing to leave the dollars in the policy until the executive's death and accepting the financial risk of underperformance and any negative accounting impact.

Summary

In the current economic and tax environment, LRSD is an efficient executive compensation planning option. Careful attention to structuring the underlying loan as demand or term and recourse or nonrecourse will help balance the parties' respective risks and rewards.

Learn more about executive benefits, institutional asset management, and benefit liability management at www.BFBbenefit.com. For more information about this article, please contact TJ Telford at TJ_Telford@ajg.com or 801-231-2495.

Endnotes

1. Based on Line 20 Call Reports, growing from 255 credit unions in Q1-2014 to 356 credit unions in Q2-2015.
2. Even though the arrangement may not constitute a loan for other purposes. For example, the underlying policy can be owned jointly by the executive and the credit union, in which case the credit union never parts with ownership and control of the funds in the policy, so no legal loan is made. This distinction is important for state-chartered credit unions in states that prohibit officer loans. Nevertheless, for ease of presentation, in this article we refer to the credit union's premium payments as loans.
3. The executive could be required to pay some interest and to report the balance in income. For imputed income, the credit union might also agree to pay a bonus to cover the taxes on the loan, or allow the executive to borrow the taxes from the policy.
4. 26 C.F.R. § 1.7872-15(b)(2).
5. *Id.* § 1.7872-15(b)(3).
6. For example, the split dollar agreement may have a general "do no harm" clause, such as the parties cannot do anything that would harm the other's rights under the arrangement. Demanding the loan would harm the executive's rights.
7. In Frank Lyon Co. v. United States, 435 U.S. 561, 573, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978), the Supreme Court explained:

    In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The Court has never regarded "the simple expedient of drawing up papers," Commissioner v. Tower, 327 U.S. 280, 291, 66 S. Ct. 532, 90 L. Ed. 670, 1946-1 C.B. 11 (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws, and the courts, are concerned with substance and realities, and formal written documents are not rigidly binding." Helvering v. Lazarus & Co., 308 U.S. [252, 255, 60 S. Ct. 209, 84 L. Ed. 226, 1939-2 C.B. 208 (1939).]
8. The IRS sets the BAR assuming the dollars earn interest for the first half of the year at the January short-term AFR, and interest for the second half of the year at the July short-term AFR. Therefore, the BAR for a year is not set until June when the IRS announces the July short-term AFR.
9. The AFR history, together with the most recently published rates, are available at www.SPLawFirm.net/afr.
10. EITF Issue No. 06-10, *Accounting for Collateral Assignment Split Dollar Life Insurance Arrangements,* March 15, 2007.
11. 26 C.F.R. § 1.7872-15(d)(2)(ii). Credit unions do not file "Federal income tax returns" so it is not clear how this requirement applies to the credit union's filing requirement. Typically, state-chartered credit unions attach the representation to their Form 990 for the year the premium is paid, and federal credit unions do not file the representation but rather keep it for their records.
12. *Id.* § 1.7872-15(d)(2)(i).