



Advanced Markets

Planning in Action

Loan Regime Split Dollar used by a non-profit organization as a key employee-retention plan

Case in point

An advisor is working with the head of Human Resources of a non-profit hospital that has been experiencing a higher than usual rate of key highly-paid employees leaving for other jobs. While the organization has increased compensation to key employees, they are looking for creative long-term benefit ideas that will provide additional incentive for those employees to stay with the organization. One employee they worry about in particular is the remaining practitioner of a niche specialty within the organization, as he would be difficult to replace. The advisor suggests a deferred compensation plan under §457(f), but the at-retirement taxation to the employee for the future benefits is not appealing. Are there other ideas? The advisor calls Advanced Markets to discuss options.

Client profile

- Key employee, male, age 49, in good health
- Employer = hospital
 - Hospital's goal is to provide a benefit for key employee that will incentivize the employee to stay with the hospital

Designing a case & creating a plan

Our Advanced Markets Consultant (AMC) and the advisor began their discussion by reviewing several options, including a Section 162 Bonus, Restrictive Endorsement Bonus Arrangement (REBA) and Loan Regime Split Dollar (LRSD). Concept presentations, insurance illustrations and marketing materials were provided and discussed. While the advisor thought all the ideas had merit, feedback from his client led him to suggest that the LRSD would be the best fit.

In the LRSD concept, the employee owns the policy and the hospital pays the annual policy premium (as a loan). The hospital has a collateral assignment on the policy equal to the outstanding loan until either repayment or the assignment is released, presumably at retirement. The employee treats the annual split dollar loan interest as imputed income and pays tax on the interest. The LRSD interest rate illustrated in year one is 2.15% (long-term Applicable Federal Rate for February 2020). In year two

and beyond, the annual rate is projected to cycle up 20 basis points, to a cap of 3.5%, and then cycle down. The hospital is willing to make an annual bonus to the employee to cover the tax on the split dollar loan interest so that the employee has zero out-of-pocket cost while actively at work. This 16-year bonus total is \$109,738.

Because they want to encourage the employee to stay 16 years until age 65, the hospital commits to spending \$50,000 annually for that duration to the plan (\$800,000 total plus the bonus for taxes). The collateral assignment is a key selling point to the hospital, because if the employee leaves early they can recoup their loan directly from the policy. Should the employee remain working at the hospital to retirement, the hospital intends to release the collateral assignment, which would be a taxable event to the employee (but is not expected to create an excise tax under §4960 as cumulative loan balance won't exceed \$1M). The plan is designed so that the employee can pay the tax due on the release of the collateral assignment in year 17 (\$280,000 at 35%) by making a distribution (loan) from the policy's cash value. Additional annual policy distributions at the employee's discretion for years 18-32 are built into the plan.

The hospital carefully considers the structure of the policy, as it is an important element in the plan design. The focus is on growing cash value using minimum death benefit (non-MEC). After careful consideration of a number of products, the hospital felt most comfortable with John Hancock's Accumulation Indexed UL because it offers upside growth potential with downside protection. Risk mitigation assumptions for the product illustration include using:

- **5.5% policy crediting rate in the Capped Account** (current max illustration rate is 5.92%)
- **Endow for lifetime**, as the cash value target for the policy distributions solve years 18-32
- **Annual mode for cash value distributions**
- **The Overloan Protection feature** (protects policy from lapse under certain conditions if loans become too large)

As part of the hospital's due diligence, the insurance illustrations were run as a 1) death benefit option 1/CVAT design and 2) a death benefit option 2 switch to option 1/GPT design using three different loan types, as follows:

- **Standard loan**
- **Fixed indexed loan** using 5.0% loan rate
- **Indexed loan** using 6.0% loan rate

The hospital opts to use the death benefit option 2/GPT design, because it projects to provide higher policy cash value and death benefit at age 65. The employee controls the policy after the collateral assignment is released and can choose how best to use the policy for his needs, including the timing and amount of annual policy distributions, if any, and the loan type that works best for him. Based on the illustrated assumptions, the annual policy distribution for years 18-32 could range from \$68,120 to \$83,177 depending on the loan type used. The actual amount will be based on the historical performance of the policy and the timing of the distributions (e.g., if he delays or skips years). Alternatively, the employee could choose to use the policy death benefit for family or estate needs and leave the policy cash value intact. These are decisions the employee will make in conjunction with his overall financial planning at that time.

The illustration results of these combinations considered by the hospital are summarized below:

Loan regime split dollar (LRSD) illustrations summary

Male, age 49, Standard Plus Non-Smoker, Accumulation IUL '19, \$50K annual premium for 16 years, minimum non-MEC DB

Vitality PLUS at Gold Status, CSV solve to endow lifetime, 5.5% crediting rate, Overloan Protection selected

	Death benefit option 1/CVAT			Death benefit option 2 switch/GPT		
	Standard loan	Fixed indexed loan (5.5%)	Indexed loan (6.0%)	Standard loan	Fixed indexed loan (5.5%)	Indexed loan (6.0%)
Initial face amount		\$1,465,321			\$1,029,248	
CSV year 16 (age 65)		\$1,021,259			\$1,065,384	
DB year 16 (age 65)		\$2,050,178			\$2,094,632	
Total bonus from ER for imputed income year 16		\$109,738			\$109,738	
EE total outlay year 16		\$0			\$0	
Policy loan yr. 17 (pay tax on LRSD assignment release)		\$280,000 (35% tax bracket)			\$280,000 (35% tax bracket)	
Policy distributions years 18-32 (15 yrs.)	\$69,417	\$81,695	\$71,437	\$68,120	\$83,177	\$78,689
Total policy distributions year 32	\$1,321,255	\$1,505,425	\$1,351,555	\$1,301,800	\$1,527,655	\$1,460,335
CSV year 32 (age 81)	\$229,047	\$116,952	\$235,350	\$245,816	\$97,819	\$100,084
DB year 32 (age 81)	\$535,157	\$526,968	\$672,261	\$662,071	\$159,578	\$163,335

The data shown is taken from illustrations. Values are not guaranteed and certain assumptions are subject to change by the insurer. Actual results may be more or less favorable.

Why it works

A Loan Regime Split Dollar (LRSD) plan is a natural fit for a non-profit organization that wants to encourage key employees to remain with the organization. The plan offers several benefits to both the employer and employee. For a start, it falls outside of IRC §457, which means the employee avoids lump-sum taxation on a future benefit stream. In addition, minimal administration is required, especially compared to a §457 plan, which would require a third-party administrator. At the same time, the collateral assignment on the policy protects the organization at least up to the amount of the policy's cash value during years when that value is less than the outstanding loan. And the employee has flexibility to use the policy to meet personal needs during lifetime or at death, with potential projected annual policy distributions of cash value in this example ranging from \$68K to \$83K. Finally, the advisor and John Hancock used available product features and conservative assumptions to help reduce plan risk.

Resources



**JH Solutions
presentation:
Loan Regime
Split Dollar**
(for client use)

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Call Advanced Markets at *888-266-7498, option 3*, to speak with an *Advanced Markets Consultant*.

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Loans and withdrawals will reduce the death benefit, cash surrender value, and may cause the policy to lapse. Lapse or surrender of a policy with a loan may cause the recognition of taxable income. Policies classified as modified endowment contracts may be subject to tax when a loan or withdrawal is made. A federal tax penalty of 10% may also apply if the loan or withdrawal is taken prior to age 59 1/2.

The cost of an index loan can vary substantially compared to that of a standard loan and the risk of policy lapse is greater than it would be with a standard loan. See the policy illustration and "Understanding Potential Loan Costs" for further details.

Index loans and Fixed Index Loans are available after the third policy year.

Index loan and Fixed Index loan requests in excess of the Indexed Appreciation Account will be secured by balances transferred from the Fixed Account to a Loan Account.

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Page 4 of 4. Not valid without all pages.