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Split-Dollar Accounting: Loan Arrangements

Part 2 of 4-Part Series

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Split-dollar is a compensation arrangement involving a cash value life insurance policy. The employer and an executive agree to share the policy's death proceeds and sometimes the premiums, cash value, or both. While split-dollar was a very popular form of benefit at one time, legislative,¹ tax,² and accounting changes³ have made it much less popular. New plans are almost nonexistent and employers continue to terminate existing plans.

This is the second in a series of four articles covering the topic of split-dollar accounting, and specifically addresses accounting for loan arrangements. It presumes that the reader has read the first article, "Categorizing Split-Dollar Arrangements," and determined that a particular arrangement is a postretirement loan arrangement for accounting purposes. Although relatively few arrangements

meet the narrow criteria for loan treatment for accounting purposes, such arrangements do exist, and require the application of fairly complex accounting methodology.

In the past, the accounting treatment for these arrangements was quite favorable, and as a matter of practice, did not involve imputing interest as compensation expense. Since the end of 2007, companies have been required to discount these loan arrangements and recognize a corresponding benefit expense. However, many companies still have not implemented this practice, and if they have, may not be doing so correctly because of a failure to understand the difference between loan treatment for tax and accounting purposes, or an unintentional disregard for the effects of attribution.

This article discusses the specifics of how to account for this type of arrangement and highlights some of the key issues, such as how discount rates for accounting purposes differ from the Applicable Federal Rates (AFR) used for tax purposes. It also proposes a methodology for imputing interest as compensation expense for accounting purposes that differs from the methodology used for tax purposes.

HISTORICAL PERSPECTIVE

Before Sarbanes-Oxley effectively prohibited collateral assignment split dollar for publicly traded companies in 2002, these arrangements were quite prevalent. Favorable accounting motivated companies to lend executives significant amounts of money at little or no interest.

One form this type of arrangement took was a SERP Swap, in which an executive swapped SERP benefits for a collateral assignment split-dollar arrangement. The executives expected to benefit from the arrangement by being able to transfer wealth to their heirs more efficiently, and the company benefitted by being able to reverse its previously recognized SERP expense without having to recognize a new benefit expense. Reflecting this accounting practice, the Winter 2001 issue of the *Journal of Deferred Compensation*⁴ included this excerpt:

“ . . .to the extent that the company is relieved of liability under the SERP/NQDC benefits ‘swapped’ by the executive, the company can book income on the cancellation of the liability.”

Example 1: An executive waives a \$1.2M SERP payment in favor of a \$1.0M zero interest split-dollar loan payable at death. The company reverses the SERP accrual and related deferred tax asset (assumed 40% tax rate) to create a \$720K

immediate one-time increase in net income. The \$720K reflects the reversal of both the \$1.2M SERP liability and the related \$480K deferred tax asset. Common practice permitted the company to avoid any benefit accrual for the present value loss of tying up \$1.0M without interest until the executive's death.

In retrospect, it is difficult to understand why auditors did not consistently require that companies apply Accounting Principles Board Opinion No. 21, *Interest: Imputation of an Interest Cost* (APB 21), to such arrangements. Applying APB 21 to the arrangement would have resulted in imputing forgone interest as compensation expense. Although at least one national accounting firm's official position was that APB 21 *did* apply to all collateral assignment split-dollar arrangements, many companies managed to avoid applying APB 21 to such arrangements. One reason for this diversity in accounting practice may have been the confusion between accounting and taxation.⁵ The fact that such arrangements were rarely taxed as loans may have helped create the illusion that imputed interest was not necessary. Also, many companies focused on the accounting guidance for the cash surrender value of the policy as collateral instead of the interest-free loan nature of the arrangement. This focus on the cash value may have been the result of a 1984 AICPA Issues Paper that proposed that an entity's share of premiums paid under a split-dollar plan "should be accounted for in the same manner as other key-person life insurance policies."⁶ The Financial Accounting Standards Board (FASB) issued Technical Bulletin 85-4, *Accounting for Purchases of Life Insurance*, in November of 1984 without specifically addressing the accounting for split dollar. Nevertheless, the ability to avoid any benefit expense while incurring a significant net present value loss defied the economic substance of the transaction.

EFFECT OF EITF 06-10

To bring uniformity to accounting for collateral assignment split-dollar arrangements, FASB ratified the consensus reached by the Emerging Issues Task Force (EITF) in Issue 06-10, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements*. With an effective date of fiscal years beginning after December 15, 2007, EITF Issue 06-10 requires companies to recognize a benefit liability for collateral assignment arrangements when such arrangements are substantially similar to endorsement split-dollar arrangements. When a collateral

assignment arrangement distinguishes itself from an endorsement arrangement by meeting the criteria for a loan receivable from the executive, EITF 06-10 requires companies to follow APB 21 in accounting for its loan receivable. Requiring companies either to recognize a liability or to discount a loan receivable means that nearly all postretirement collateral split-dollar arrangements result in a benefit expense. This expense is in addition to any expense created by premiums in excess of cash surrender value. Postretirement collateral assignment split-dollar arrangements that do not require accrual of a benefit expense require the executive to pay market interest or market term insurance rates.

GUIDANCE UNDER SUBTOPIC 835-30

US GAAP has long required companies to reflect the time value of money when accounting for contractual rights to receive or contractual obligations to pay money on fixed or determinable dates. Subtopic 835-30 codifies APB 21 and labels such rights and obligations as notes. As noted in the first article in this series, certain forms of collateral assignment split dollar meet the criteria for a note receivable or loan arrangement. Therefore, companies that charge zero interest or below market interest on a postretirement split-dollar loan arrangement must impute the present value loss as compensation expense.

The guidance in EITF 06-10 is now codified in Subtopic 715-60, *Compensation—Retirement Benefit—Defined Benefit Plans—Other Post-retirement*. Paragraph 715-60-55-181 cross-references Subtopic 835-30, *Interest—Imputation of Interest*, for recourse arrangements that the company intends to enforce. A recourse arrangement is an arrangement that requires the executive to repay the loan in full, even when the loan balance exceeds the value of the insurance policy as collateral. Because many executives have valid concerns about having to pay such a short-fall, recourse arrangements are rare.

Section 835-30-25 gives limited guidance on imputing interest as compensation expense under “Note Exchanged for Property, Goods, or Services.” Split dollar can be an example of a note exchanged for services. Section 835-30-25 explains that notes represent two elements: a principal amount and an interest factor. For example, the swapped SERP liability (net of deferred tax savings) would be the principal amount in a SERP swap.

Example 2: Using the facts from Example 1, the company’s agreement to loan \$1M interest-free for the executive’s life expectancy of 40 years suggests that the present value loss

of such an arrangement is equal to the amount of the SERP obligation that would have otherwise been paid, less the deferred tax savings. The following projection assumes that the \$1M premium is paid in five installments.

Consider these observations about imputing interest as compensation expense in this example:

- The \$720K net present value loss equals the imputed compensation expense, which equals the after-tax value of the SERP obligation.
- The \$720K net present value loss on the split-dollar cash flows implies a discount rate of 4.04%.
- Premiums create “good” accounting results. They reduce the liability, convert the liability into an asset, or increase the asset.

Example 2:

	Cash Flow Beg of Yr	Asset/(Liab) Beg of Yr	Interest (Exp)/Inc	Asset/(Liab) End of Yr
1	-\$200,000	-\$720,000	-\$20,992	-\$540,992
2	-200,000	-540,992	-13,766	-354,758
3	-200,000	-354,758	-6,248	-161,006
4	-200,000	-161,006	1,574	40,568
5	-200,000	40,568	9,712	250,280
6	0	250,280	10,104	260,384
7	0	260,384	10,512	270,896
10	0	293,209	11,837	305,046
15	0	357,369	14,427	371,796
20	0	435,568	17,584	453,152
25	0	530,878	21,432	552,310
30	0	647,044	26,121	673,165
35	0	788,630	31,837	820,467
40	0	961,196	38,804	1,000,000
41	1,000,000			
Sum	0		\$720,000	
NPV at 4.04%	-\$720,000			

- Interest on the discounted liability creates interest expense, whereas interest on the discounted asset creates interest income.
- The \$1M received at death comprises the recovery of the \$1M in cumulative premiums, \$720K in net interest income, and the negative \$720K principal amount.

The last observation is probably the least intuitive. Because the company is entitled to recover its cumulative premiums, the \$1M received at death obviously includes the cumulative premiums. The \$1M receivable at death also includes all the interest income earned on the discounted receivable over the 40-year period. Note that the receivable grows each year as the interest income is earned. Also note that the \$720K in cumulative interest includes interest expense (negative interest) incurred while the present value was a liability. Finally, the \$1M received at death reflects the original \$720K liability, which reflected the original net present value loss. Absent that original liability, the amount due would be \$1.72 million. Another way of looking at the accounting is viewing the \$720K of net interest income as paying off the original \$720K liability. In practical terms, death rarely occurs at the original life expectancy. Instead, life expectancy extends slightly each year, which reduces the interest income. In the year of death, the actual recovery will exceed the present value of the expected recovery. This causes a windfall gain in the year of death (the more premature the death, the greater the windfall gain).

Although a SERP swap creates an obvious principal amount that implies a certain discount rate, most split-dollar arrangements are not swaps. Without an obvious principal amount treated as imputed compensation expense, accounting for most split-dollar loan arrangements requires the determination of a discount rate in order to calculate the net present value loss to be treated as compensation expense.

Example 3: Using the insurance cash flows from the swap example, suppose that the executive does not swap other compensation for the split-dollar arrangement. If the discount rate were 4.04%, the present value loss would be \$720K to be treated as nondeductible compensation expense.

Discount Rate for Accounting Purposes

Subtopic 835-30 requires that the discount rate reflect the rate that an independent borrower and lender would have negotiated given the same circumstances.⁷ This rate is not necessarily equal to the imputed

interest rate used for tax purposes. In fact, the rate for accounting purposes likely exceeds the AFR used for tax purposes. While the AFR reflects interest rates on US Treasury obligations, most split-dollar participants/borrowers have lower credit ratings than the Federal government, and therefore, pay higher interest rates. Mortgage rates might be one of the most appropriate benchmarks for collateralized long-term loans. Determination of the appropriate discount rate for accounting purposes is made at inception. Subsequent changes in prevailing interest rates are ignored.⁸

Some employers charge interest on collateral assignment split-dollar arrangements. The rate is usually the long term AFR for split-dollar loans payable at death. Instead of requiring the executive to pay interest in cash, these arrangements usually add interest to the loan balance. When the loan rate charged (e.g., long term AFR) is less than the benchmark used for accounting purposes (e.g., 30-year fixed rate loan), the spread between the two rates creates imputed compensation expense.

Example 4: An employer loans an executive \$200K per year for five years, payable with interest at the long term AFR of 4.04% at the executive's death. If the executive's life expectancy is 40 years, the loan balance at death will be over \$4.5M. If the appropriate discount rate for accounting purposes is 5%, the present value loss is \$269K. This amount is imputed as nondeductible compensation expense for accounting purposes, despite the lack of any imputed income for tax purposes.

INAPPROPRIATE METHODOLOGY

Most loan arrangements for accounting purposes use either demand loan methodology or term loan methodology. Both methodologies are usually inappropriate for accounting purposes because they fail to consider attribution, which is the "process of assigning postretirement benefit cost to periods of executive service."⁹ Although Subtopic 835-30, *Imputation of Interest*, provides no specific guidance on attribution, Subtopic 715-60, *Defined Benefit Plans—Other Postretirement*, does.¹⁰ In the case of a below market note receivable, the discounting of the future collection of the note reflects a post-retirement benefit expense. The guidance on attribution in Subtopic 715-60 states that an equal amount of expense generally should be assigned to each year of service during the attribution period.¹¹ The

attribution period ends on the full eligibility date, which is often the retirement date for pay-related plans, but may be the vesting date for plans that are not pay-related.¹² A benefit is pay-related when future changes in compensation affect the benefit.¹³

Example 5: A split-dollar arrangement that meets the criteria for loan accounting creates a present value loss of \$720K. If the benefit is immediately vested and not pay-related, the \$720K benefit expense is recognized immediately. This is the situation in the SERP swap, where the expense has already been recognized.

Example 6: If the benefit vests after 10 years and is not pay-related, the benefit expense is recognized over the 10-year vesting period. The first year expense is \$72K, or one tenth of the present value loss. Each year of the remaining vesting period reflects a similar expense.

Example 7: If the benefit is pay-related, the benefit expense is recognized over the years of expected future service. If the expected future service is 15 years, the first year expense is \$48K, or one-fifteenth of the present value loss. Each year of the remaining expected service period reflects a similar expense.

If the executive retires after meeting the vesting criteria but before reaching the expected retirement date, the balance of the imputed benefit expense is recognized in the year of retirement.

Spreading the foregone interest imputed as compensation expense over the attribution period assigns the benefit expense to the years in which the benefit is earned. Neither the demand loan methodology nor the term loan methodology considers the timing of when split-dollar benefits are earned. Instead, these tax methodologies can obscure or distort accounting results.

Demand Loan Methodology

Companies that have split-dollar notes receivable on demand often follow the income tax methodology for demand loans. The interest imputed as compensation expense equals the outstanding loan balance times an interest rate. As annual premiums increase the outstanding loan balance, the interest imputed as compensation expense increases.

Example 8:

Year	Age	Loaned Premiums BOY	Loan Balance	Asset BOY	Imputed Compensation Expense Et 4.04%	Imputed Interest Income	Net Income
1	50	-\$200,000	\$200,000	\$200,000	-\$8,074	\$8,074	\$0
2	51	-200,000	400,000	400,000	-16,148	16,148	0
3	52	-200,000	600,000	600,000	-24,222	24,222	0
4	53	-200,000	800,000	800,000	-32,296	32,296	0
5	54	-200,000	1,000,000	1,000,000	-40,370	40,370	0
6	55	0	1,000,000	1,000,000	-40,370	40,370	0
7	56	0	1,000,000	1,000,000	-40,370	40,370	0
8	57	0	1,000,000	1,000,000	-40,370	40,370	0
9	58	0	1,000,000	1,000,000	-40,370	40,370	0
10	59	0	1,000,000	1,000,000	-40,370	40,370	0
11	60	0	1,000,000	1,000,000	-40,370	40,370	0
12	61	0	1,000,000	1,000,000	-40,370	40,370	0
13	62	0	1,000,000	1,000,000	-40,370	40,370	0
14	63	0	1,000,000	1,000,000	-40,370	40,370	0
15	64	0	1,000,000	1,000,000	-40,370	40,370	0

Note that imputed interest as compensation expense is also interest income. Imagine that the executive pays the interest each year and the employer bonuses the executive an equal amount. The employer's simultaneous imputation of compensation expense and interest income creates zero effect on net income. Although the zero effect on net income may appear to be a desirable result, the employer has not accrued the postretirement imputed interest as compensation expense. When a demand loan arrangement creates an expected postretirement benefit, demand loan methodology requires separate accrual of the expected postretirement imputed interest as compensation expense over the attribution period. Without such an accrual, using demand loan methodology for accounting purposes results in a failure to accrue the postretirement benefit expense. The fact that the employer can cancel the arrangement at any time is irrelevant. Just as employers must accrue for expected postretirement medical benefits that can be cancelled at any time, employers must

accrue for expected postretirement split-dollar expense. Demand loan methodology obscures benefit expense by matching interest income against the benefit expense and fails to accrue postretirement imputed interest as compensation.

Term Loan Methodology

Whereas demand loans inappropriately postpone benefit expense, term loan methodology can inappropriately accelerate the benefit expense. Term loan methodology creates a benefit expense with each premium payment. The amount of the benefit expense is the expected present value loss at the time of premium.

Example 9: An employer loans a split-dollar premium of \$200K interest-free until the executive's expected death in 40 years. The discount rate is 4.04%. The discounted principal amount is \$41,022, which results in a present value loss of \$158,978 imputed as compensation expense. Because the timing of the recognition of compensation expense depends on the timing of the premium, the company may be able to control the timing of expense recognition by controlling the timing of premiums.

The \$158,978 may overstate or understate the benefit expense that reflects attribution. The amount overstates benefit expense if the amount exceeds the total present value loss attributable to past service.

Example 10: Same facts as Example 9. The \$200K premium is the only expected premium and the \$158,978 net present value loss reflects the loss on the entire arrangement. If the attribution period is 10 years, the imputed compensation expense for the first year should be \$15,897, or one-tenth of the net present value loss. An imputed benefit expense of \$158,978 would overstate the \$15,897 expense that reflects attribution.

The amount understates benefit expense if the amount is less than the present value loss attributable to past service on all premiums.

Example 11: Same facts as Example 9, but the \$200K premium is the first of five premiums and the executive is fully vested. The recognition of \$158,978 of interest imputed as

compensation expense substantially understates the \$720K of compensation expense that reflects the total net present value loss attributable to past service.

Methodology That Reflects Attribution

The following example reflects both the net present value loss on the entire arrangement and a 15-year attribution period.

Consider these observations about imputing interest as compensation expense for multiple premiums over an attribution period that includes future service:

- The discount (net present value loss) is the present value of imputed compensation expense.
- Premiums create “good” accounting results. Premiums reduce a liability, convert a liability into an asset, or increase an asset. In this example, the first year premium converts an otherwise \$48K liability into an asset.
- Interest imputed as compensation expense creates “bad” accounting results. Such expense increases a liability, converts an asset into a liability, or reduces an asset. In this example, the cumulative premiums always exceed the cumulative compensation expense, so the compensation expense reduces the asset created by the premiums.
- The \$1M received at death comprises the recovery of the \$1M in cumulative premiums, \$964K in interest income, and \$964K in compensation expense. The interest income and the compensation expense cancel each other out.

Example 12:

Year	Age	Cash Flow Beg of Year	Asset/ (Liab) Beg of Year	Comp Exp Beg of Year	Interest (Exp)/ Inc	Asset/ (Liab) End of Year	Net Income
1	50	-\$200,000	\$0	-\$48,000	\$6,136	\$158,136	-\$41,864
2	51	-200,000	158,136	-49,938	12,442	320,640	-37,496
3	52	-200,000	320,640	-51,954	18,921	487,608	-33,033
4	53	-200,000	487,608	-54,051	25,577	659,133	-28,474
5	54	-200,000	659,133	-56,233	32,413	835,313	-23,820

Year	Age	Cash Flow Beg of Year	Asset/ (Liab) Beg of Year	Comp Exp Beg of Year	Interest (Exp)/ Inc	Asset/ (Liab) End of Year	Net Income
6	55	0	835,313	-58,503	31,360	808,170	-27,143
7	56	0	808,170	-60,865	30,169	777,473	-30,696
8	57	0	777,473	-63,322	28,830	742,981	-34,492
9	58	0	742,981	-65,879	27,335	704,437	-38,544
10	59	0	704,437	-68,538	25,671	661,571	-42,867
11	60	0	661,571	-71,305	23,829	614,095	-47,476
12	61	0	614,095	-74,183	21,796	561,707	-52,387
13	62	0	561,707	-77,178	19,560	504,090	-57,618
14	63	0	504,090	-80,294	17,109	440,904	-63,185
15	64	0	440,904	-83,535	14,427	371,796	-69,108
16	65	0	371,796		15,009	386,805	15,009
20	69	0	435,568		17,584	453,152	17,584
25	74	0	530,878		21,432	552,310	21,432
30	79	0	647,044		26,121	673,165	26,121
35	84	0	788,630		31,837	820,467	31,837
40	89	0	961,196		38,804	1,000,000	38,804
41		1,000,000					
Sum		\$0		-\$963,779	\$963,779		\$0
NPV at 4.04%		-\$720,000		-\$720,000			

ACCOUNTING CORRECTIONS

The examples discussed above illustrate the complexity of split-dollar loan accounting. Not surprisingly, many companies with post-retirement split-dollar arrangements that meet loan accounting criteria have not imputed forgone interest as compensation expense. Some missed the deadline for adopting EITF 06-10, which had an effective date of fiscal years beginning after December 15, 2007. Others have implemented arrangements since 2007 and were never aware that below market loan accounting might apply.

Applying below market loan accounting to an existing arrangement is a correction of an error. When such a correction is material, Topic 250 provides guidance on retrospective application to prior

periods. Net income for the current period excludes corrections of errors from prior periods. The correction of errors that are not material is outside the scope of Codification. Companies reflect the cumulative effect of correcting an immaterial error in the current period. Materiality is outside the scope of this article.

SUMMARY

Few collateral assignment split-dollar arrangements meet the criteria for loan treatment for accounting purposes. The criteria for loan treatment include the ability and intent to collect the loan, and ensuring that the executive bears all the risk of the policy performance. Nonrecourse arrangements may not meet these criteria.

When a collateral assignment split-dollar arrangement does meet the criteria for loan treatment for accounting purposes, any forgone interest is imputed as compensation expense. Companies should be aware that the discount rate for accounting purposes may exceed the AFR used for tax purposes. Any such excess will create imputed compensation expense even when the company charges the executive interest at the AFR for tax purposes. The imputed benefit expense for a particular year should reflect both the entire net present value loss for the entire arrangement and the attribution period. Spreading the net present value loss across the attribution period is the most effective way to assign the imputed benefit expense to the period or periods in which it is earned.

NOTES

1. Section 402 of the Sarbanes-Oxley Act of 2002 prohibits publicly-traded companies from providing personal loans to directors and executive officers. Certain types of split-dollar arrangements can be considered personal loans.
2. IRS Notice 2002-8 requires split-dollar arrangements that were not terminated before January 1, 2004, to be taxed either as loans or economic benefits. Earlier arrangements created the opportunity for income tax-free transfers of life insurance cash values to executives. Arrangements entered into or modified after September 17, 2003, are taxed under the less favorable Treasury Regulation §§ 1.61-22 and 1.7872-15.
3. Accounting changes are the focus of this article.
4. See "SERP SWAP," Michael Brink, Laura Thatcher, and Mark Williamson, *Journal of Deferred Compensation*, Winter 2001.
5. For example, IRS Notice 2002-8 allowed arrangements entered into before September 18, 2003, to elect either loan taxation or economic benefit taxation. In contrast, accounting treatment is nonelective and determined by facts and circumstances.
6. See AICPA Issues Paper "Accounting for Key-Person Life Insurance," Paragraph 39 under Proposed Alternative Methods.

7. Paragraphs 835-30-25-12 and 25-13.
8. Paragraph 835-30-25-11.
9. Section 715-60-20 (glossary).
10. Paragraphs 715-60-35-61 through 35-70 and Paragraphs 715-60-55-56A through 55-59.
11. Paragraph 715-60-35-62.
12. Paragraph 715-60-35-68.
13. Section 715-60-20 (glossary).