VOLUME 38, NUMBER 2

SUMMER 2012

JOURNAL *of* PENSION PLANNING & COMPLIANCE

Editor-in-Chief: Bruce J. McNeil, Esq.

Split-Dollar Accounting: Categorizing the Arrangement

Part 1 of a 4-Part Series

LEE NUNN

Lee Nunn, CPA, is a senior vice president in Aon Hewitt's Executive Benefits practice. He may be reached at *Lee.Nunn@aonhewitt.com.*

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 changes[3] have made it much less popular. New plans are almost nonexistent and employers continue to terminate existing plans.

This is the first in a series of four articles that will help employers that still have plans in place interpret the somewhat complex accounting guidance on split-dollar. This article covers a brief history of accounting for split-dollar and then

Wolters Kluwer
Law & Business

helps employers categorize their split-dollar arrangements into one of four possible categories. The four categories include preretirement arrangements that do not require accrual and three categories of post-retirement benefit arrangements. The remaining articles will address the accounting methodology for each category of postretirement benefit.

HISTORY

The history of split-dollar accounting helps explain the need for postretirement benefit expense accrual and why FASB's Emerging Issues Task Force (EITF) decided to categorize split-dollar arrangements for accounting purposes. In 2005, the EITF became aware of significant diversity in accounting practice for endorsement split-dollar.[4] Endorsement arrangements are arrangements in which the employer owns the policy and endorses a portion of the death benefit to a beneficiary designated by the executive.[5] Some accounting firms were requiring their audit clients to accrue postretirement benefits provided under these arrangements. Many of these audit clients were community banks.[6] Under the typical arrangement, a community bank paid a single premium and claimed death benefits equal to the cash value of the policy. The bank endorsed death proceeds in excess of the cash value to the beneficiary named by the executive. Banks protested the accrual of postretirement benefits and emphasized that the insurance company would pay the benefits.

When the EITF first discussed the issue, it believed that the accounting for other types of split-dollar arrangements was consistent.[7] The EITF believed that employers who sponsored collateral assignment split-dollar policies were recording these arrangements as below market loan arrangements and were imputing interest as compensation expense.[8] Collateral assignment arrangements are arrangements in which the employee owns the policy and assigns a portion of policy values to the employer as collateral for premium loans.[9] Ironically, the accounting for such loans was in fact consistent; it was just not in the form that the EITF believed. Employers capitalized premium loans to employees, but rarely recognized compensation expense. The EITF also believed that endorsement arrangements in which the employer guaranteed the death benefit were recorded on a consistent basis.[10] The EITF believed that these employers were properly recording postretirement benefit expense for the benefit they had guaranteed.[11] Although the accounting for these arrangements may have been consistent, employer guarantees of postretirement death benefits were rare.

After extensive discussion, the EITF reached a consensus on endorsement split-dollar accounting and FASB ratified EITF Issue

06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements." Issue 06-4 categorized all postretirement endorsement split-dollar arrangements as either agreements to maintain a policy or agreements to provide a death benefit. Both arrangements resulted in preretirement accruals of postretirement benefits. Agreements to maintain a policy required the accrual of the postretirement cost of insurance related to the endorsed death benefit, even when no future premiums would be paid and the employer expected to recover all of its premiums at death.[12] Agreements to provide a death benefit required the accrual of the promised death benefit.[13]

Having addressed endorsement split-dollar accounting, the EITF revisited accounting for collateral assignment split-dollar arrangements. Research by the EITF staff confirmed that the Sarbanes-Oxley Act's prohibition on personal loans to executive officers had dramatically reduced the prevalence of collateral assignment split-dollar.[14] However, the EITF identified a valid concern that endorsement split-dollar arrangements could be restructured as nonequity collateral assignment arrangements in order to circumvent the need to accrue postretirement benefits.[15]

> *Example:* An employer planned to purchase a $100,000 single premium life insurance policy and allow the insured executive to name the beneficiary for any death proceeds in excess of the cash value. The employer would not guarantee the death benefit and expected to receive death proceeds equal to the cash value on the death of the insured executive. Because EITF 06-4 required the accrual of the cost of providing the death benefit to the executive's beneficiary, the employer considered arranging for the executive to own the policy. The employee would collaterally assign the cash value to the employer in exchange for the employer's single premium. The economics of the arrangement are the same regardless of ownership of the policy.

After relatively little discussion, the EITF reached a consensus on collateral assignment split-dollar accounting and FASB ratified EITF Issue 06-10, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements." Issue 06-10 required employers to account for collateral assignment split-dollar arrangements based on the substantive agreement with the employee.[16] Analysis of the substantive agreement distinguishes loan arrangements from the equivalent of endorsement split-dollar arrangements.

CODIFICATION

EITF Issues 06-4 and 06-10 are now part of Codification subtopic 715-60.[17] FASB codified the essential elements of US GAAP as of July 1, 2009, into a single source: *FASB Accounting Standards Codification*™ (Codification), which supersedes all previous US GAAP.[18] The old hierarchy that included Statements (Financial Accounting Standards, or FAS) down to Staff Positions (Financial Staff Positions, or FSP) is now a unified single source, searchable by topic and cross-referenced with pre-Codification Standards. FASB intended to codify, not change, US GAAP. However, FASB acknowledges that "combining disparate standards into a codified format introduces the possibility of unintentional changes." Codification allows constituent feedback on content in order to identify unintentional changes, and to alert FASB of the need for intentional changes as part of the ongoing standard setting process.

CATEGORIZING SPLIT-DOLLAR ARRANGEMENTS

Subtopic 715-60 results groups all split-dollar arrangements into one of four categories:

1. Arrangements that do not provide postretirement benefits (preretirement arrangements)

2. Loan arrangements

3. Agreements to pay a benefit

4. Agreements to maintain a policy

Codification recognizes that split-dollar arrangements come in many forms and avoids making many definitive statements.[19] Instead, the guidance in Subtopic 715-60 uses wording such as "would provide an indication" or "may indicate." Although this wording implies that the complexity of split-dollar arrangements does not lend itself to simple categorizing rules, the guidance does provide some important themes that distinguish arrangements for accounting purposes.

PRERETIREMENT ARRANGEMENTS

Split-dollar arrangements that limit the benefit to the employee's active service period do not require accrual of a postretirement benefit.[20] Instead, any potential expense is recognized when it becomes probable that a preretirement death will occur.[21]

Example: An employer allows an insured executive to name the beneficiary for $1 million of death proceeds if he dies before retirement. On the balance sheet date, the cash value is $100,000, but the employer's share of the death proceeds is only $90,000. The employer should reduce the asset to $90,000 only if preretirement death is probable.

LOAN ARRANGEMENTS

Few split-dollar arrangements meet the criteria for loan accounting. Loan arrangements are limited to collateral assignment policies, which are not owned by the employer.[22] Instead, the executive or someone designated by the executive owns the policy.

Despite the popularity of collateral assignment split-dollar, only certain collateral assignment arrangements qualify for loan accounting. Although many people assume that loan taxation of collateral assignment arrangements determines the accounting treatment, that is not the case. In fact, the only factor that loan accounting and loan taxation have in common is that they are both limited to collateral assignments. Not all collateral assignment arrangements are loans for accounting purposes and not all collateral assignments arrangements are loans for tax purposes. However, the criteria for loan treatment differ for tax and accounting purposes.

Loan treatment for tax purposes depends partly on the timing of the collateral assignment arrangement. Loan treatment for arrangements entered into before September 18, 2003, is elective for tax purposes.[23] Loan treatment for arrangements entered into or modified after September 17, 2003, excludes arrangements in which the only economic benefit to the employee is term life protection. The split-dollar regulations treat such arrangements as endorsement split-dollar.[24] All collateral assignment arrangements entered into after September 17, 2003, that include economic benefits other than term life insurance protection are taxed as loans.[25] Loan treatment for tax purposes does not depend on the level of risk shifting between the employee and employer.

In contrast, loan treatment for accounting purposes depends heavily on keeping the risk of policy ownership with the employee. The risks of policy ownership include the possibility that the insurance company will default on benefits due under the policy and the possibility that additional premiums will be necessary to avoid a lapse of coverage. Subtopic 715-60 lists several features of collateral assignment arrangements that are inconsistent with loans because they shift the risk of policy ownership back to the employer. An employer's agreement to maintain a policy[26] or agreement to guarantee a death benefit in the event of

the insurance company's default[27] disqualifies a collateral assignment arrangement from loan accounting.

> *Example:* An employer and employee entered into a collateral assignment arrangement covered by Notice 2002-8 and have elected loan treatment for tax purposes. The employer has first claim to cash value and death benefit equal to its cumulative premiums. The arrangement commits the employer to pay postretirement premiums to build the employee's share of the cash value to a level that will avoid lapse of coverage under certain assumptions. Declining interest rates have caused the employer's premiums to increase. Because the employer bears the risk of poor policy performance until the release of the employee's cash value, the employer has agreed to maintain a policy subject to a collateral assignment. Such an arrangement does not qualify for loan accounting despite its treatment as loan for tax purposes.

Failing to meet the accounting standards for loan arrangements can happen in subtle ways. Many employers want to assure participants in split-dollar plans that the coverage will last long enough for the participants to receive a benefit, and many participants have valid concerns about the expected performance of the policies. Any real or implied commitment by the employer to loan premiums to maintain a policy after retirement indicates an agreement to maintain a policy. The absence of any legal obligation to pay loan premiums after retirement does not guarantee loan treatment for accounting purposes. Codification presumes that the employer will continue to pay premiums postretirement despite any legal commitment to do so.[28] Conditioning those premium payments on policy performance may indicate a postretirement benefit obligation.[29] Even charging market interest on the loan balance is not a guarantee that the arrangement is a loan for accounting purposes, when the employer has a real or implied commitment to loan premiums to maintain a policy after the employee's retirement.

> *Example:* An employer pays premiums on a life insurance policy owned by the executive in exchange for a collateral assignment. The arrangement is a nonrecourse arrangement for tax purposes, and the parties have a signed the required written representation that "a reasonable person would expect that all payments under the loan will be made."[30] The split-dollar agreement provides the executive's beneficiaries with a death benefit equal to the total death proceeds, less

> the employer's cumulative premiums accumulated at the long-term Applicable Federal Rate. If the loan balance at death exceeds the death proceeds payable to the employer, the shortfall is considered taxable wages at the employee's death.[31] The employer has agreed to loan premiums post-retirement in order to avoid such a shortfall at death if the policy performance deteriorates. Because the capitalized loan interest equals at least the Applicable Federal Rate, the arrangement is not a below market loan for tax purposes and does not create imputed interest as taxable wages, as long as the loan is eventually repaid in full. However, the possibility of postretirement premiums may indicate a benefit obligation that makes the arrangement ineligible for loan accounting.

One risk of policy ownership that characterizes a bona fide loan arrangement for accounting purposes is the possibility that the split-dollar loan balance at death will exceed the policy proceeds. In this situation, the employer claims all of the death proceeds. In a recourse arrangement, the employee's estate is liable for any shortfall between the loan balance and the death proceeds received by the employer. The estate uses other assets to pay this shortfall. Subtopic 715-60 cross-references the guidance for imputation of interest on below market loans only for recourse arrangements.[32]

In a nonrecourse arrangement, the employer's ability to collect this loan is limited to the policy values. Nonrecourse collateral assignment arrangements are particularly difficult to categorize because the employee's risk of ownership is so much lower than it is in a recourse arrangement. An underfunded policy that is expected to lapse illustrates the issue. If the policy does lapse, a nonrecourse arrangement shields the employee from having to repay the loan and the employer receives nothing. The employee has neither the obligation nor the ability to repay the employer.[33] Obviously, no independent lender makes a loan with the expectation of complete default. Lenders who do make nonrecourse loans usually insist on a higher level of collateral than they would in a recourse loan arrangement. A loan made on collateral with market risk, such as a variable life insurance policy invested in equity funds, requires an even greater level of collateral. A collateral assignment arrangement on a variable policy that has experienced such poor investment performance that it is expected to lapse, may not reflect a loan arrangement that would have been negotiated between independent parties.

> *Example:* An employer pays $1 million in premiums on a nonrecourse collateral assignment second-to-die variable life

insurance policy insuring an employee and the employee's spouse. The initial death benefit reflected the assumption that the cash value would earn 10% each year, and the employer expected to recover its $1 million in premiums at the death of the survivor. The investment performance has been significantly less than 10% and the policy is expected to lapse, absent additional premiums or a reduction in death benefit. If the original terms support loan treatment, the asset equals the discounted value of expected future cash flows, which reflect the possibility of death before lapse. This discounted amount may be significantly less that the current cash surrender value, which may be significantly less than the original discounted amount of the expected recovery of the $1 million. Additional premium payments by the employer to avoid lapse may be consistent with loan arrangement for accounting purposes. The employer just might be protecting its collateral, especially when the employer expects to receive 100% of the death proceeds.

An employer's agreement to pay loan premiums after the employee's retirement does not automatically preclude loan treatment for accounting purposes. This is especially true when premiums are not contingent on policy performance and the loan is either recourse or heavily collateralized. However, an employer that chooses loan accounting for such an arrangement may have to vigorously challenge the presumption that it has agreed to maintain a policy.

Example: An employer has agreed to pay the fixed annual premium on a whole life policy owned by the insured employee until the employee dies. Through a collateral assignment, the employer claims cash value and death benefits equal to its cumulative premiums. The arrangement is somewhat analogous to a committed credit line, where the lender is legally obligated to a lend funds up to a certain sum. The employee's beneficiary will receive any death proceeds in excess of the employer's claim. The employer has the right to exercise the reduced paid-up nonforfeiture right if the cash value is ever less than loan amount and the employee refuses to pay the loan balance in cash. If the death proceeds are insufficient to repay the split-dollar loan, the employee's estate is obligated to pay any shortfall back to the employer. If the arrangement is terminated during the employee's lifetime, the employee is

> obligated to pay the employer an amount equal to any shortfall between the cash value and the split-dollar loan. The employee and his estate bear all the risks of policy ownership. Despite the employer's obligation to pay postretirement premiums, the arrangement is a loan for accounting purposes regardless of the tax treatment.

Even when the employer demonstrates that there is no implied agreement to maintain a policy postretirement, loan accounting treatment still requires the employee's obligation and ability to repay the loan.[34] An employer's informal agreement to waive repayment of the loan at a future date under limited circumstances may indicate a lack of intent to collect the loan balance. Likewise, a nonrecourse arrangement in which the cash values are invested in funds with significant market risk may indicate the employee may not be obligated to repay the split-dollar loan in a down market.

These examples demonstrate the narrowness of loan arrangements for accounting purposes. Collateral assignment arrangements that do not meet the criteria for loan accounting follow endorsement split-dollar accounting.[35] All endorsement split-dollar arrangements that do not limit benefits to the employee's active service period (Category 1) are either agreements to pay a benefit or agreements to maintain a policy.[36]

AGREEMENTS TO PAY A BENEFIT

Agreements to pay a benefit include arrangements in which the death benefit payable to the executive's beneficiary is not explicitly tied to the insurance policy.[37] For example, a postretirement death benefit equal to twice the executive's final salary is not tied to the policy, because the death proceeds from the policy could be insufficient to pay the benefit. Likewise, the employer's agreement to pay a death benefit in the event the insurance company defaults is an agreement to pay a benefit.[38] Failing to limit the death benefit payable to the executive's beneficiary to the death proceeds payable by the policy is unusual. Most split-dollar arrangements accounted for under the endorsement method are agreements to maintain a policy.

AGREEMENTS TO MAINTAIN A POLICY

An agreement to maintain a policy is the most common category of postretirement split-dollar arrangement. The employer limits the death benefit to the policy proceeds and does not guarantee any benefit above those proceeds. Postretirement premiums may or may not

be paid. Instead of accruing the proceeds received by the executive's named beneficiary, agreements to maintain a policy accrue the real or implied internal mortality charges within the life insurance product.[39]

SUMMARY

Understanding the history of split-dollar accounting and the guidance in Codification subtopic 715-60 enables employers to categorize split-dollar arrangements into one of four categories: Arrangements that do not provide postretirement benefits; Loan arrangements; Agreements to pay a benefit; or Agreements to maintain a policy. Identifying the category determines the accounting methodology, which will be the focus of the remaining articles in this four-part series in the *Journal of Pension Planning & Compliance*.

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* paragraph 2 of EITF Issue 06-4 Issue Summary No. 1, dated February 20, 2006.
5. Section 715-60-20.
6. *See* paragraph 3 of EITF Issue 06-4 Issue Summary No. 1, Supplement No. 2, dated August 18, 2006. FASB staff had received comment letters from 119 separate organizations and individuals as of August 18, 2006. 91 of these were from banks. 85 of the letters were one of four "form" letters. All but two letters disagreed with the EITF's tentative conclusion to require accrual of postretirement split-dollar benefits.
7. *See* paragraph 10 of EITF Issue 06-4 Issue Summary No. 1, dated February 20, 2006.
8. *See* paragraphs 3 and 5 of EITF Issue 06-10 Issue Summary No. 1, dated October 23, 2006.
9. Section 715-60-20.
10. *See* paragraph 11 of EITF Issue 06-4 Issue Summary No. 1, dated February 20, 2006.
11. *Id.*
12. *See* Exhibit 06-4B on page 21 of EITF Issue 06-4 Issue Summary No. 1, Supplement No. 2, Revised, dated August 18, 2006. The facts in the example assume a single premium policy.
13. *See* paragraph 5 of the EITF's Abstract for Issue No. 06-4.
14. *See* paragraph 3 of EITF Issue 06-10 Issue Summary No. 1, dated October 23, 2006.
15. *See* paragraph 4 of EITF Issue 06-10 Issue Summary No. 1, dated October 23, 2006.

16. *See* paragraphs 5 and 6 of the EITF's Abstract for Issue No. 06-10.
17. *See* paragraphs 715-60-35-177 through 35-185 and paragraphs 715-60-55-176 through 55-181.
18. For more background on Accounting Standards Codification™, read Notice to Constituents (v 3.0) "About the Codification" available on *FASB.org.*
19. Paragraph 715-60-05-14.
20. Paragraph 715-60-15-21.
21. Subtopic 450-20 *Loss Contingencies.*
22. Paragraphs 715-60-55-180 and 55-181.
23. IRS Notice 2002-8 allows an election between loan taxation and economic benefit taxation for arrangements entered into before September 18, 2003 (the effective date of the split dollar regulations). Even endorsement arrangements could have elected loan treatment. *See* Notice 2002-8, Section IV, Paragraph 3.
24. Treas. Reg. § 1.61-22(c)(1)(ii)(A)(1).
25. Treas. Reg. § 1.7872-15.
26. Paragraph 715-60-55-180.
27. Paragraph 715-60-55-179.
28. Paragraph 715-60-35-183.
29. Paragraph 715-60-55-180.
30. Treas. Reg. § 1.7872-15(d)(2)(ii).
31. Treas. Reg. § 1.7872-15(h)(1)(iv).
32. *See* the second the last sentence in Paragraph 715-60-55-181.
33. *See* the first sentence of Paragraph 715-60-55-181.
34. Paragraph 715-60-55-181.
35. Paragraph 715-60-35-180.
36. *Id.*
37. Paragraph 715-60-55-179.
38. *Id.*
39. Paragraph 715-60-35-178 requires employers that agree "to maintain a life insurance policy during the employee's retirement" to accrue the postretirement "cost of the insurance policy." The sample journal entries for View A' in Exhibit 06-4B starting on page 23 of EITF Issue 06-4 Issue Summary No. 1, Supplement No. 2, Revised, dated August 18, 2006, assume a single premium policy. The preretirement benefit expense is an accrual of the postretirement adjusted cost of insurance charges within the policy.

© 2012 Aspen Publishers. All Rights Reserved.
Reprinted from *JPPC* Summer 2012, Volume 38, Number 2, pages 65 to 75,
with permission from Aspen Publishers, a Wolters Kluwer business,
New York, NY, 1-800-638-8437, www.aspenpublishers.com.