

VOLUME 38, NUMBER 3

FALL 2012

JOURNAL *of*  
PENSION  
PLANNING &  
COMPLIANCE

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



# Split-Dollar Accounting: Agreements to Pay a Benefit

Part 3 of a 4-Part Series

**Lee Nunn and Mike Bost**

---

Lee Nunn, CPA, is a senior vice president in Aon Hewitt's Executive Benefits practice. He may be reached at [Lee.Nunn@aonhewitt.com](mailto:Lee.Nunn@aonhewitt.com).

Mike Bost, FSA, EA, is a Partner in Aon Hewitt's Retirement Practice located in Winston-Salem, NC. Mike has over 28 years of experience in consulting with clients on a wide range of issues involving defined benefit as well as other postretirement plans, including the valuation of postretirement death benefit obligations in split-dollar arrangements for a large financial institution. He may be reached at [Mike.Bost@aonhewitt.com](mailto:Mike.Bost@aonhewitt.com).

**S**plit-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,<sup>1</sup> tax,<sup>2</sup> and accounting changes<sup>3</sup>

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

This is the third in a series of four articles and presumes that the reader has read the first article, “Categorizing Split-Dollar Arrangements,” and determined that a particular arrangement is an agreement to pay a benefit for accounting purposes. Although relatively few arrangements meet the narrow criteria for treatment as an agreement to pay a benefit, such arrangements do exist. This article discusses the nature of these arrangements from a conceptual point of view, as well as how to account for the liability, the asset, and the payment of the death benefits.

### **AGREEMENTS TO PAY A BENEFIT ARE RARE**

---

Split-dollar arrangements categorized as agreements to pay benefits imply that the employer is the primary obligor for the postretirement death benefit.<sup>4</sup> The most common circumstance in which the employer becomes the primary obligor is when the employer promises to pay benefits in the event that the insurance company defaults.<sup>5</sup> This is rare, but such arrangements do exist. An even less common circumstance is when the split-dollar benefit is not explicitly tied to the policy.<sup>6</sup> This creates a situation where the benefit could exceed the policy death proceeds.

*Example 1:* Company A enters into a split-dollar agreement that provides the insured executive’s beneficiary with a post-retirement death benefit equal to three times his final salary. The fact that the benefit is not limited to the life insurance policy death proceeds creates the possibility that the benefit could exceed those policy death proceeds. Even though Company A has not explicitly promised to pay the benefit if the insurance company defaults, the failure to limit the death benefit to the policy death proceeds creates an agreement to pay a benefit. Any probability that the split-dollar benefit will be settled 100% by a portion of the policy death proceeds is irrelevant.

### **INSURANCE COMPANY AS PAYING AGENT FOR EMPLOYER**

---

When the employer is the primary obligor for the postretirement split-dollar benefit, accounting guidance treats the insurance company as the paying agent for the employer. The benefit

accounting mimics an arrangement in which the employer pays a lump sum death benefit directly to the executive's beneficiary—an arrangement known as a death benefit only (DBO) arrangement. When the employer is treated as the primary obligor for the benefit, the employer is also treated as the primary owner of the life insurance policy. Regardless of whether the executive, the executive's trust, or the employer is the legal owner of the policy, the insurance company is paying the benefit on the employer's behalf. Although the taxation of an agreement to pay a benefit differs from a DBO arrangement, tax accounting is completely separate from benefit accounting under US GAAP.

*Example 2:* Instead of entering into a split-dollar arrangement, Company A enters into a DBO arrangement in which it will pay a postretirement lump sum death benefit, equal to three times the executive's final salary, directly to the executive's beneficiary. Company A finances the arrangement with a corporate-owned life insurance (COLI) policy that is identical to the policy in Example 1. In spite of the differences in taxation between split-dollar and DBO arrangements, the benefit obligations of the two arrangements are identical. Likewise, both arrangements reflect the full cash surrender of the COLI policy as an asset.

## **ACCOUNTING FOR THE BENEFIT OBLIGATION**

---

As with any other postretirement benefit, accounting for the benefit obligation under the agreement begins with the calculation of the Accumulated Postretirement Benefit Obligation (APBO) under ASC Subtopic 715-60. The calculation of the APBO is a multi-step actuarial process which will be very familiar to actuaries who do valuations for other types of postretirement plans.

### **Step One: Project the Death Benefit Pattern**

Projecting the death benefit pattern is simple when the death benefit is uniform throughout the postretirement period. This is the case in Example 1 above in which the postretirement benefit is three times final salary. After retirement, the benefit never changes. However, not all arrangements are so simple. Some arrangements include a step-down pattern in which the benefit grades down in percentages based on attained age. Other arrangements base the executive's death benefit on the policy death benefit. For example, the executive's death benefit might be the total death benefit less the employer's cumulative premiums. The total death

benefit, the employer's cumulative premiums, and residual death benefit to the executive can be three different amounts that change each year. An employer's guarantee of a death benefit formula can be an agreement to pay a benefit despite the use of the policy to measure or deliver that benefit.

### **Step Two: Apply a Mortality Table to the Projected Death Benefit**

Applying a mortality table to the projected death benefit pattern determines the expected timing of the death benefit pattern. The mortality table enables the employer's actuary to estimate the probability of the executive's being alive at each attained age and then dying within the following year. The executive is less and less likely to survive each future year of retirement, but more and more likely to die within each year. The result is a projection of net expected employer cash flows that change each year. The variations in the amounts reflect both the changing probabilities of payment and sometimes different benefit amounts.

### **Step Three: Discount the Amount and Timing of Projected Benefits**

This step requires matching the rates of return on high-quality fixed income investments to the amount and timing of projected benefits.<sup>7</sup> In other words, matching different discount rates to the timing of postretirement benefits reflects a yield curve, and the amount of the benefit in each year determines the weighting of the individual rates. The result is a hypothetical portfolio of high-quality fixed income investments that is projected to provide the necessary cash flows to pay the benefits when due.<sup>8</sup> The value of this hypothetical portfolio is the present value of benefits.

### **Step Four: Spread the Present Value over the Attribution Period**

Spreading the present value calculated in Step Three over the attribution period assigns a service cost to each year in which the benefit is earned. The attribution period ends on the full eligibility date.<sup>9</sup> For arrangements that are not pay-related, the full eligibility date is the vesting date. The APBO can be thought of as the accumulation of all prior years' service cost with interest.

*Example 3:* Company B enters into a split-dollar agreement that provides the insured executive's beneficiary with a post-retirement death benefit equal to \$1 million. The vesting

criteria are age 55 with 10 years of service. The benefit expense for an arrangement on a policy issued to an executive age 48 is spread over the 10 years ending at age 58.

For arrangements in which the benefit varies with changes in pay, the full eligibility date is the expected date of retirement.<sup>10</sup> An executive who retires before that date creates an actuarial loss to fully accrue the present value of the benefit in the year of retirement.

*Example 4:* Company A enters into a split-dollar agreement that provides the insured executive's beneficiary with a postretirement death benefit equal to three times his final salary. The vesting criteria are age 55 with 10 years of service, but the expected retirement age is 65. The benefit expense for an arrangement on a policy issued to an executive age 48 is spread over the 17 years ending at age 65 because the executive can continue to earn additional benefits until retirement. If the executive retires at age 60, the difference between the previously accrued liability (APBO) and full present value of the benefit is an actuarial loss.

## CONTRIBUTORY PLANS

---

Additionally, some split-dollar arrangements require the executive to pay a portion of the premium during retirement. For these agreements, the retiree's expected payments are netted against the expected death benefits when projecting the net cash flows.<sup>11</sup> The rate used to measure the term cost for tax purposes in a grandfathered split-dollar arrangement may significantly understate the mortality risk for accounting purposes. Split-dollar arrangements entered into before (and not materially modified after) January 28, 2002, may be permitted to use a very low rate published by the carrier but not necessarily sold on a regular basis. The purchase of such a low premium term product requires thorough underwriting and might not reflect the probability of death many years after the issue date.

*Example 5:* Company A entered into an agreement to maintain a split-dollar policy with an executive in 1990. The executive is now retired and 80-years-old. Company A uses the carrier's published one-year term rate to measure the executive's term contribution for tax purposes. The published unisex annual rate for an individual 80-years-old is \$11.40

per \$1,000 of coverage. Absent current medical information that would justify such a low mortality rate for the accounting valuation, the executive's contribution will reduce, but not eliminate, the benefit obligation when measured using current mortality tables common for postretirement benefit valuations.

A postretirement split-dollar arrangement that requires employee contributions based on IRS Table 2001 might result in a benefit obligation of zero because the employee contributions fully reflect the adjusted cost of insurance.

*Example 6:* Company A entered into an agreement to maintain a split-dollar policy with an executive in 2003. The executive is now retired and 80-years-old. Company A uses IRS Table 2001 to measure the executive's term contribution for tax purposes. The annual rate for an individual 80-years-old is \$54.56 per \$1,000 of coverage. Company A might not have a benefit obligation since the executive's projected contributions may approximate the true actuarial cost of the death benefit as measured by the commonly used RP 2000 mortality table.

## **ACTUARIAL GAINS AND LOSSES**

---

As noted in Example 4, the early retirement of an executive in a pay-related plan is an example of an actuarial loss. Actuarial gains and losses comprise both differences between experience and assumptions and changes in those assumptions.<sup>12</sup> An agreement to pay a benefit creates an actuarial gain each postretirement year the executive survives. This gain reflects the increased life expectancy, given that the executive survived the year, which delays the expected benefit payments and consequently lowers the present value of the benefits. Actuarial valuations of split-dollar typically assume zero preretirement mortality.

*Example 7:* Company A enters into a split-dollar agreement that provides the insured executive's beneficiary with a postretirement death benefit equal to three times his final salary. The executive's life expectancy when the arrangement begins is age 85. If the executive survives to age 85, his life expectancy will be even longer. That increase in life expectancy is recognized incrementally each year during retirement.

Because the benefit obligation reflects ever-increasing life expectancy, the benefit obligation never assumes 100 percent probability that the executive will die in the current year unless the executive survives the mortality table. When the executive does die, the difference between the previously accrued liability (APBO) and the actual benefit is an actuarial loss.

*Example 8:* Company B enters into a split-dollar agreement that provides the insured executive's beneficiary with a post-retirement death benefit equal to \$1 million. By the time of the executive's death at age 80, Company B has accrued a benefit obligation of \$725K. Company B records an actuarial loss of \$275K in the year of death to fully accrue the \$1 million benefit.

### **LIFE INSURANCE CASH VALUE AS AN ASSET**

---

As the primary obligor for the benefit, the employer's benefit obligation fully accounts for the benefit. Because the cash value is available to general creditors, it is not a plan asset and must follow life insurance accounting. Under life insurance accounting, the company records the full cash surrender value of the policy as an asset. Any reduction of the asset below the full cash surrender value of the life insurance policy would represent double counting of the benefit expense. This is true regardless of who owns the policy. When the employer is the primary obligor for the benefit, the employer is the primary owner of the life insurance policy for accounting purposes. An agreement to pay a benefit reflects a benefit obligation and a life insurance asset just as if the employer were financing a DBO arrangement with COLI. The employer should reflect cash value even in excess of its expected share of the death proceeds. As we will see in the next section, any recorded cash value in excess of the employer's share of death proceeds will reduce the insurance gain at death.

*Example 9:* Consider Examples 1 and 2, which compare a split-dollar agreement to pay a benefit with a COLI financed DBO arrangement for the same benefit amount and with same life insurance policy. The split-dollar agreement reflects the same benefit obligation as the DBO and the same cash value as the COLI asset. Recording an asset below the full cash surrender value for the split-dollar arrangement creates an expense that exceeds the expense for the COLI financed DBO. Any such difference in expense reflects inappropriate

double counting of expense because the benefit obligation fully reflects the present value of the benefit attributable to past service.

### **ACCOUNTING FOR THE DEATH BENEFIT**

---

The journal entries at death are the most confusing aspect of accounting for agreements to pay a benefit. The confusion stems from the cashless settlement of the obligation and the indirect receipt of life insurance proceeds payable to the executive's beneficiary. Fortunately, much of the journal entry is straightforward:

- **Cash:** Record receipt of the employer's share of the death proceeds
- **Benefit Obligation:** Reverse the now fully accrued amount
- **Cash Value:** Reverse the previously recorded amount

The more complicated piece of the journal entry ties all the pieces together. This is the insurance gain at death, which is the same insurance gain that the employer would have recorded in a COLI financed DBO arrangement.

*Example 10:* Assume the same facts as Example 6. The employer now has a benefit obligation of \$1 million. In addition, assume that the employer receives its cumulative premiums of \$500K in addition to the executive's benefit of \$1 million (for total death proceeds of \$1.5 million) and that the previously recorded cash value is \$900K. Note that the recorded cash value of \$900K exceeds the employer's share of the death proceeds by \$400K. The employer makes the following journal entry.

Cash	\$500,000	
Benefit obligation	\$1,000,000	
Cash value		\$900,000
Gain on insurance		\$600,000

*To record the receipt of the split-dollar death proceeds and the settlement of the split-dollar benefit obligation*

Note that the \$600K gain on insurance exceeds the \$275K actuarial loss recognized in Example 6. Note that the \$600K insurance gain



equals the excess of the \$1.5 million in total death proceeds over the \$900K cash value. This is the same result as COLI accounting.

If the employer had limited its asset to the \$500K it recovered in cash, the gain at death would have been \$1 million. Therefore, limiting the cash value inappropriately increases the gain at death at the expense of increasing insurance expense during the employee's lifetime.

## **OTHER ISSUES**

---

Two other issues deserve mention. The first issue is the recognition of actuarial gains and losses in postretirement benefit plans. Although most employers with postretirement benefit plans choose to delay recognition of actuarial gains and losses to smooth net income, the authors believe that best practice for agreements to pay a benefit is to reflect actuarial gains and losses immediately through net income. During lifetime, immediate recognition allows the employer to reflect the actuarial gains from increased life expectancy in net income. At death, the immediate recognition of the actuarial loss to fully accrue the benefit helps to offset the insurance gain, which is not eligible for delayed recognition. Instead all life insurance gains and losses flow through net income. Another reason in favor of immediate recognition of gains and losses is it avoids dealing with potential settlement calculations with partial acceleration of recognition of gains and losses each time an executive dies.

The second issue is the situation in which a portion of the cash value is beyond the reach of corporate creditors. This is the case for certain collateral assignment arrangements in which the total cash value exceeds the employer's claim of its cumulative premiums. The excess of total cash value over the employer's claim to the cash value is labeled employee "equity." When the equity portion of cash value is beyond the reach of creditors, that equity can qualify for treatment as a plan asset. Such treatment allows the employer to offset the equity against the obligation, net the gains in equity against the benefit expense, and delay recognition of changes in equity.

## **ACCOUNTING CORRECTIONS**

---

The examples discussed above illustrate the complexity of split-dollar agreements to pay a benefit. Not surprisingly, many companies with postretirement split-dollar agreements to pay a benefit have not accrued a benefit obligation. Some missed the 2008 deadline for

accruing postretirement split-dollar obligations.<sup>13</sup> Others have implemented arrangements since 2007 and were never aware that benefit obligation accounting might apply.

Accruing a benefit obligation for an existing arrangement is the correction of an error in previously issued financial statements.<sup>14</sup> 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 split-dollar arrangements meet the criteria for agreements to pay a benefit, because most companies do not guarantee the benefit and limit the benefit to the life insurance policy death proceeds. When a split-dollar arrangement does meet the criteria for an agreement to pay a benefit, the company must accrue a liability for the actuarial present value of the benefit, an asset for the full cash surrender value of the policy, and an insurance gain at death.

## 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. Paragraph 715-60-55-178.
5. Paragraph 715-60-55-179.
6. *Ibid.*
7. Paragraph 715-60-35-80.
8. *Ibid.*
9. Paragraph 715-60-35-68.
10. *Ibid.*
11. Paragraph 715-60-35-57.
12. Paragraph 715-60-35-23.

13. Both EITF Issue 06-4, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements* and EITF Issue 06-10, *Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements*, were effective for fiscal years beginning after December 15, 2007.
14. Section 250-10-20 (glossary).