Executive Benefits Solutions

A Practical Guide to Accounting for Loan Regime Split Dollar Arrangements

Introduction

Split dollar arrangements have been used for many years to provide life insurance and deferred compensation benefits for highly compensated executives and professionals. However, they have received heightened interest in recent years, especially among non-profit organizations, because of the new 21% excise tax on excessive compensation and the widely reported programs for a number of high-profile coaches.

One of the oft-cited advantages of a loan regime split dollar arrangement is the relatively favorable accounting treatment in comparison to a Supplemental Executive Retirement Plan or other non- qualified deferred compensation program. It is sometimes said that a loan regime split dollar arrangement, “converts compensation expense into an asset.” As explained more fully below, that statement may be correct under only limited circumstances.

CAVEAT

Executive Benefit Solutions is an executive compensation and benefits consulting firm. It does not provide legal, tax or accounting advice. The accounting information and examples below are based on the firm's anecdotal experience with clients and their advisors and is presented for illustration purposes only. There are a number of different forms of split dollar arrangements, and a plan sponsor should consult with its accounting and tax advisors to ensure proper accounting treatment.

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BACKGROUND

Prior to 2006, the conventional thinking was that a split dollar arrangement did not create any net expense to the sponsoring organization. To address the inconsistent accounting treatment, the FASB Emerging Issues Task Force in 2006 issued EITF 06-04, “Accounting for Deferred Compensation and Post retirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements,” and EITF 06-10, “Accounting for Collateral Assignment Split-Dollar Life Insurance Arrangements.” These EITF Abstracts have since been incorporated into ASC Topic 715-60.

Two issues are addressed:

- Whether the nature of the arrangement is such that the sponsor should recognize a liability and a benefit expense regarding any post-retirement benefit provided and,
- How to recognize and value the related asset.

CURRENT ACCOUNTING TREATMENT

The first step in determining the appropriate accounting treatment for a loan regime split dollar program is to determine the proper classification of the arrangement for accounting purposes, ***which is often different from the classification for tax purposes.***

TAX CLASSIFICATION

For tax purposes, a loan regime split dollar arrangement is generally classified based on policy ownership. Of course, there is an exception to the general rule, but in most cases a split dollar plan will be treated as a loan regime arrangement if:

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- the policy is owned by the service provider (employee or independent contractor),
- premium payments are made by the non-owner (the employer),
- there is a reasonable expectation of full repayment and,
- the loans are secured by the policy values.

If the premium loans are interest free or if the interest paid or accrued is at a below-market rate, Section 7872 requires the imputation of interest based on the difference between the Applicable Federal Rate and the rate specified for the premium loans. In many cases, interest is accrued or imputed at the AFR – the long-term rate in effect at the time the loans are made in the case of term loans, and the short-term AFR in the case of demand loans.

GAAP Classification

For accounting purposes, the criteria are different. A split dollar arrangement that provides a post-retirement benefit is classified into one of 3 categories:

- a loan arrangement,
- an agreement to pay a post-retirement benefit or,
- an agreement to maintain a policy in force after retirement.

Rather than look simply to policy ownership, the key determinant of "loan" classification for accounting purposes is the substance of the employer's obligation:

- Is the plan a defined contribution arrangement that is limited to the payment by the employer of a specific stream of premium payments? Or, has the employer explicitly or implicitly agreed to make additional premium payments, if necessary, to ensure the delivery of a target benefit or to keep the policy in force until a certain age?
- Which party bears the risk of under performance of the policy – the employer or the participant? If, at some point, it becomes clear that projected future policy values will be insufficient to deliver the target benefit or to fully repay the premium loans, will the employer make additional premium payments? Or, it is clear to both parties that the participant is at risk for under performance of the policy and other risks, such as an adverse change in interest rates?
- If the premium loans are structured as non-recourse loans, does the interest rate represent a market rate that a commercial lender would charge to reflect the risk of less than full repayment? Or, is interest being paid / accrued / imputed based on the AFR?

Arrangements That Meet "Loan" Criteria

If a loan regime split dollar arrangement ***meets the criteria*** outlined above for "loan" classification for accounting purposes, no benefit liability or expense would be recognized. The cumulative premium loans plus accrued interest would be recorded as "Notes Receivable" on the balance sheet, subject to valuation considerations outlined below.

Arrangements That Do Not Meet "Loan" Criteria

If the split dollar arrangement ***does not meet the criteria*** for "loan" accounting treatment, a benefit liability should be recorded, and benefit expense accrued based on the substance of the employer's obligation under the plan:

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- If it represents a promise to pay a post-retirement death benefit, the actuarial present value of the death benefit as of the full eligibility (vesting) date should be accrued over the employee's service period to the full eligibility date.
- If the substance of the employer's obligation is to maintain a policy in-force on the life of the employee after retirement, the present value of the projected cost (not premium) to maintain the policy in retirement should be accrued over the employee's service period to the full eligibility date.

Recognition and Valuation of the Loan Regime Split Dollar Asset

If a split dollar arrangement ***meets the criteria*** for "loan" treatment, the plan sponsor should record the premium advances as "Notes Receivable," subject to possible valuation adjustments:

- *If non-recourse loans*, the "Notes Receivable" asset should be recorded at the lesser of the aggregate amount of premium loans plus accrued interest, or the amount of the related collateral - the cash surrender value of the life insurance policy(ies).
- *If recourse loans*, the recorded value of the "Note Receivable" asset should take into consideration the time value of money based on the guidance provided in ASC 835-30 / APB 21, "Interest on Receivables and Payables." In that case, it may be necessary to recognize a discounted value based on the present value of the projected future stream of interest and principal payments at a market rate that reflects the characteristics of the premium loans.

If a split dollar arrangement ***does not meet the criteria*** for "loan" treatment for accounting, the related balance sheet asset would be "Cash Surrender Value of Life Insurance" rather than "Notes Receivable."

HYPOTHETICAL ACCOUNTING EXAMPLE 1

The following is a simplistic example of the accounting treatment for loan regime split dollar arrangements structured in a commonly used fashion.

Example 1 Assumptions

- *Nature of the employer's obligation:* A defined contribution arrangement. The Employer has made no promise (explicitly or implicitly) to make additional premium loans, if necessary, to ensure delivery of a target benefit.
- *Risk of policy performance:* Both parties clearly understand that the participant bears the risk of policy under-performance.
- *Premium Structure:* A single non-recourse loan in the amount of $2,000,000 paid into a premium deposit account with the life insurance carrier from which annual premiums will be paid into the policy(ies) over 7 years.
- *Interest on the premium loans:* Accrued at 3.0% - the long-term AFR in effect at the date of the loan.
- *Repayment of the Premium Loans and Accrued Interest:* From the policy death benefit.

Accounting for Loan Regime Split Dollar Plans

Example 1 – Accounting Treatment

- <u>*Recognition of benefit expense / liability:*</u> Based on the above assumptions, no benefit liability would be recorded, and no benefit expense would be accrued as illustrated below.
- <u>*Recognition and valuation of the related asset:*</u> The Notes Receivable asset would be recorded at the lesser of the aggregate amount of premium loans plus accrued interest or the cash value of the underlying policy(ies). The asset value would be adjusted each year through a Premium Loan Valuation Reserve account.

Projected Premium Loan Balance and Policy Values

Year	Age	(1) Cumulative Loans with Interest @ 3.0% *EOY*	(2) Projected Total Cash Surrender Value *EOY*	(3) Projected Total Death Benefit *BOY*	(4) Plan Sponsor's Share of Cash Surrender Value *EOY*	(5) Plan Sponsor's Share of Death Benefit *EOY*	(6) Annual Loan Interest Accrued *EOY*	(7) Premium Loans Receivable A/C Balance *[Lesser of Col 1 or 2]* *EOY*	(8) Premium Loans Receivable Valuation Reserve *[Col 7 - 2]* *EOY*
1	46	2,060,000	1,875,765	6,647,576	1,875,765	2,060,000	60,000	1,875,765	(184,235)
2	47	2,121,800	1,888,352	6,925,935	1,888,352	2,121,800	61,800	1,888,352	(233,448)
3	48	2,185,454	1,914,574	7,222,086	1,914,574	2,185,454	63,654	1,914,574	(270,880)
4	49	2,251,018	1,955,458	7,537,114	1,955,458	2,251,018	65,564	1,955,458	(295,560)
5	**50**	**2,318,548**	**2,011,926**	**7,872,015**	**2,011,926**	**2,318,548**	**67,531**	**2,011,926**	**(306,622)**
6	51	2,388,105	2,100,727	8,243,595	2,100,727	2,388,105	69,556	2,100,727	(287,378)
7	52	2,459,748	2,208,187	8,638,250	2,208,187	2,459,748	71,643	2,208,187	(251,561)
8	53	2,533,540	2,341,324	6,574,922	2,341,324	2,533,540	73,792	2,341,324	(192,216)
9	54	2,609,546	2,481,461	6,574,922	2,481,461	2,609,546	76,006	2,481,461	(128,085)
10	**55**	**2,687,833**	**2,629,884**	**6,574,922**	**2,629,884**	**2,687,833**	**78,286**	**2,629,884**	**(57,949)**
20	**65**	**3,612,222**	**4,885,632**	**7,465,911**	**3,612,222**	**3,612,222**	**105,210**	**3,612,222**	**0**
30	**75**	**4,854,525**	**6,308,071**	**6,769,985**	**4,854,525**	**4,854,525**	**141,394**	**4,854,525**	**0**
40	**85**	**6,524,076**	**9,502,048**	**10,386,040**	**6,524,076**	**6,524,076**	**190,022**	**6,524,076**	**0**

Assumptions:

<u>Insurance illustration:</u>

- *Penn Mutual Life's Accumulation Flex Select IUL with a 1.0% guaranteed floor, and a current cap of 10.5%.*
- *Illustrated policy values taken from carrier software reflect a 6.0% crediting rate, current expense and mortality charges (which are not guaranteed), and an underwriting rating of "Preferred Non-Tobacco."*
- *See the actual policy illustration for additional disclosures.*
- *Projected Cash Accumulation Value and Cash Surrender Value include balance in the Premium Deposit Account.*

<u>Premium Loan:</u>

- *2,000,000 loan at the beginning of year 1 paid into a Premium Deposit Account (PDA) and fed into the insurance policy over 7 years. PML currently pays interest at 2.5% on funds in the PDA, which is taxable to the participant.*
- *2,000,000 loan plus accrued interest to be repaid to Employer from the policy death benefit. Accrued interest based on the long-term AFR, assumed to be 3.0%.*
- *Non-recourse, term loan (treated as a "hybrid" loan under the split dollar regulations).*

Sample Accounting Entries

	Account	Debit	Credit	Balance Sheet Impact	P & L Impact
BOY	***To Record Premium Loan***				
	Premium Loan Receivable	2,000,000		2,000,000	
	Cash		2,000,000	(2,000,000)	
EOY	***To Adjust Premium Loan Receivable to Balance of Collateral***				
	Premium Loan Valuation Reserve Adjustment	184,235			(184,235)
	Premium Loan Valuation Reserve		184,235	(184,235)	
EOY	***Accrual of Interest on Loans***				
	Premium Loans Receivable	60,000		60,000	
	Loan interest income		60,000		60,000
Cumulative Impact Through Year 1				**(124,235)**	**(124,235)**

Year 2

	Account	Debit	Credit	Balance Sheet Impact	P & L Impact
EOY	***To Adjust Premium Loan Receivable to Balance of Collateral***				
	Premium Loan Valuation Reserve Adjustment	49,213			(49,213)
	Premium Loan Valuation Reserve		49,213	(49,213)	
EOY	***Accrual of Interest on Loans***				
	Premium Loans Receivable	61,800		61,800	
	Loan interest income		61,800		61,800
Cumulative Impact Through Year 2				**(111,648)**	**(111,648)**

Years 40 / 41

Account	Debit	Credit	Balance Sheet Impact	P & L Impact
Account Balances in Year 40 Prior to Loan Repayment			**4,524,076** [1]	**4,524,076** [2]
Year 41 Repayment of Loans				
Cash	6,524,076		6,524,076	0
Premium Loans Receivable		6,524,076	(6,524,076)	0
Premium Loan Valuation Reserve Adjustment	0			0
Premium Loan Valuation Reserve		0		0
Cumulative Impact Through Year 41			**4,524,076**	**4,524,076**

1 – The net balance sheet impact through year 40 includes the Premium Loan Receivable account balance less the initial cash investment (6,524,076 – 2,000,000)

2 – The net P&L impact through year 40 represents interest accrued on the premium loan (Premium Loan Receivable account balance including accrued interest less the principal of the premium loan (6,524,076 - 2,000,000)

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Example 2 – Assumptions

- *Nature of the employer's obligation*: A target benefit plan, with respect to which the employer may adjust the premium loan payments from time to time to ensure that the policy will stay in force and deliver the target benefit.
- *Risk of policy performance*: The employer bears the risks of under-performance of the policy.
- *Premium structure / Accrual of interest / Repayment of premium loans:* Same as Example 1.

Example 2 - Accounting Treatment

In this case, a benefit liability should be recognized, and benefit expense accrued over the service period of the participant to the full eligibility date. The amount of the liability recorded would be equal to the present value of the projected post-retirement cost (not premium) of keeping the policy in force and providing the target benefit.

The related asset would not be "Notes Receivable," but rather "Cash Surrender Value of Life Insurance."

OTHER ACCOUNTING AND TAX ISSUES TO CONSIDER

Use of the AFR versus a Market Rate of Interest

Some plan sponsors and their employment attorneys are careful to draft the split dollar documents to make sure that the sponsor's obligation is, in substance, a defined contribution arrangement, and that the Participant is at risk for policy performance. In that case, no benefit liability would be recorded, and no benefit expense would be accrued. A "Notes Receivable" asset would be recorded at the lesser of the aggregate amount of premium loans plus accrued interest or the cash surrender value of the underlying insurance contact(s).

The potential accounting issue to consider in this situation is the use of the AFR versus a market rate of interest that a commercial lender would offer for a non-recourse loan that reflects the risk of less than full repayment. It is highly likely that that rate would be higher than the AFR. Arguably, the difference between the market rate and the AFR represents a benefit to the executive provided by his or her employer which should be accrued over the service period to the full eligibility date.

However, this is not a straight-forward issue because the risk to the sponsor of less than full repayment is generally only temporary. Furthermore, if the loan regime split dollar arrangement is structured for repayment at death, the risk is further mitigated. The point is, this is an issue that should be considered and discussed with the sponsor's accountants. In our experience, after consideration of the issue, some plan sponsors simply conclude that the risk of less than full repayment is not sufficiently material to warrant the use of a higher loan interest rate that could increase the cost of the arrangement or negatively impact performance.

Tax Compliance

While the topic of this white paper is the accounting treatment for a loan regime split dollar arrangement, tax compliance is an important issue that could have an impact on accounting.

If the premium loans are structured as non-recourse, the participant and the plan sponsor are required to file a statement with each of their respective Federal income tax returns for each year the sponsor makes a premium loan. Each party must represent that a reasonable person would conclude, taking into consideration all relevant facts and circumstances, that the premium loans will be repaid in full.

If such filings are not made, the premium loans may be treated as "contingent loans" with zero repayment value. In this worst-case scenario, the premium payments would be fully expensed.

Form 990 / Proxy Disclosure

Form 990

Another potential advantage of a loan regime split dollar arrangement in comparison to a SERP or other non-qualified deferred compensation plan is the relatively favorable disclosure requirements. Specifically, the reduction or elimination of reported executive compensation since the premium advances would be reported as loans, not as compensation. It is only in the event of forgiveness of loan principal or interest that compensation would be recognized and reported.

The reporting requirements for a loan regime split dollar arrangement on Form 990 include:

- the existence of the premium loans in the Part IV Checklist,
- the interest income accrued (or received) in Part VIII, "Statement of Revenue,"
- the amount of the "Loans Receivable" reported in the Balance Sheet in Part X,
- and "Loans to/from Interested Persons" on Schedule L. The Schedule L disclosures include the purpose of the loan(s), the principal amount and current balance due, and confirmation that the loans are supported by a written agreement approved by the Board.

No compensation is required to be reported in Part VII, "Compensation of Officers, Directors….," or on Schedule J, "Compensation Information" unless there has been forgiveness of loan principal or interest.

Proxy

The enactment of the Sarbanes Oxley Act in 2002 generally eliminated the use of collateral assignment (now loan regime) split dollar arrangements for executive officers of publicly traded companies. Most corporate plan sponsors have terminated or frozen such arrangements for executive officers offered at that time. As a result, Proxy disclosure is generally not an issue.

Bottom Line

As noted in the introduction, split dollar arrangements have been used for many years to provide supplemental life insurance and deferred compensation benefits for key employees and professionals. However, they have recently received renewed interest and a great deal of publicity as a cost-effective alternative to traditional SERPs and other non-qualified deferred compensation programs, especially among non-profit organizations.

From a financial reporting standpoint, the bottom line is that a loan regime split dollar arrangement may offer relatively favorable accounting treatment if properly structured and managed. Specifically:

- The substance of the arrangement is a defined contribution plan, with respect to which the sponsor makes no promise (implicit or explicit) to deliver a target benefit or to maintain the policy in retirement,
- The participant is at risk for the under-performance of the policy,
- Consideration is given to an appropriate rate of interest on non-recourse loans that reflects market conditions and finally,
- There is compliance with the tax reporting requirements for non-recourse loans.

And finally, from a risk management standpoint, one of the most important issues to consider up front in the design of the loan regime split dollar plan is under-performance - *of the team*! That is, what happens when there is an early termination of the arrangement because the coach has been fired? That will be one of the subjects addressed in a future blog.

ABOUT EXECUTIVE BENEFIT SOLUTIONS, LLC

EBS is an independent executive benefits consulting firm which provides total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design,
- The structuring of related financing and benefit security arrangements,
- The design and management of the participant communication, education and enrollment processes,
- Management of any informal funding assets and,
- On-going plan administration and technical support.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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