FASB Emerging Issues Task Force

Issue No. 06-4

Title: Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements

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References:

FASB Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (FAS 88)

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FAS 106)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6)

FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (FTB 85-4)

APB Opinion No. 12, *Omnibus Opinion—1967* (APB 12)

International Accounting Standard 19, *Employee Benefits (IAS 19)*

*** The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. Companies purchase life insurance for various reasons that may include protecting against the loss of "key" employees, funding deferred compensation and postretirement benefit obligations, and providing an investment return. One form of this insurance is split-dollar life insurance. The structure of split-dollar life insurance arrangements can be complex and varied; however, an example of a simple structure is one in which the employer and an employee split the premiums and share the cash surrender value and/or death benefits of the insurance policy.

Common Types of Split-Dollar Life Insurance Arrangements

2. The two most basic types of arrangements are as follows:

Endorsement Split-Dollar Policies—An employer purchases a life insurance policy to insure the life of an employee. The employer enters into a separate agreement that splits the policy's premium and/or policy benefits between the employer and the employee. The employer owns the policy, controls all rights of ownership, and may terminate the benefits promised to the employee if the employee departs from the employer prior to retirement. The employer endorses a portion of the death benefits to the employee (the employee designates a beneficiary for this portion of the death benefits). Upon the death of the employee, the employee's beneficiary receives the designated portion of the death benefits and the employer receives the remainder of the death benefits. Depending on how the policy is structured, the beneficiary's proceeds are either received directly from the insurance company or from the employer (who remits the beneficiary's proportionate share once payment is received from the insurance company).

The employee's portion of the death benefits commonly is based on one of the following:

a. Amounts that exceed the gross premiums paid by the employer
b. Amounts that exceed the sum of the gross premiums paid by the employer plus an additional fixed or variable investment return on those premiums
c. Amounts equal to a multiple of the employee's base salary at retirement or death (for example, twice the employee's base salary).

Collateral Assignment Split-Dollar Policies—An employer purchases a life insurance policy to insure the life of an employee and transfers ownership of the policy to the employee. The employee (or the employee's estate or trust) owns the insurance policy and controls all rights of ownership. The employer usually pays all or a substantial part of the premium. The employee (or the employee's estate or trust) irrevocably assigns a portion of the death benefits to the employer as collateral for the employer's interest in the policy. Amounts due to the employer vary but, typically, the employer is entitled to receive a portion of the death benefits equal to the premiums paid by the employer or the premiums paid plus an additional fixed or variable return on those premiums. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy.

3. These basic arrangements often include additional provisions. For example, under an endorsement type policy, the employer may be contractually required to provide life insurance coverage to a specific employee for a specified period. These split-dollar arrangements may include an option-to-purchase provision and/or a comparable-coverage provision. Under an option-to-purchase provision, the employer is required to offer the insured employee the option to purchase the policy before the employer could sell, surrender, or otherwise transfer the policy. Under a comparable-coverage provision, the employer is required to maintain comparable coverage for the insured employee if the employer decides to switch the policy to a different carrier. These two provisions provide the employee with the security that its benefits will continue. Additionally, payments of insurance premiums may take a number of different forms including the payment of a single premium at the inception of the policy or a series of future payments.

Accounting Literature – Life Insurance

4. In 1985, the FASB issued FTB 85-4, which provides guidance on the accounting for the investment in life insurance (the asset) and requires that the amount that could be realized under the insurance contract as of the date of the financial statements be reported as an asset. Additionally, the change in the cash surrender or contract value during the period is an adjustment of premiums paid in determining the expense or income recognized for the period. Although footnote 1 in FTB 85-4 acknowledges that life insurance may be purchased to fund

deferred compensation arrangements or postemployment death benefits, it does not address the recognition of compensation costs associated with those types of benefits. Proponents of both View A and View B in this Issue Summary Supplement believe that as long as the employer is entitled to 100 percent of the cash surrender value, this entire amount would be recorded as an asset in accordance with FTB 85-4.

Accounting Guidance – Deferred Compensation and Postretirement Benefits

5. Although neither of the following references is specific to split-dollar life insurance arrangements, APB 12 provides guidance on the accounting for deferred compensation contracts with individual employees if those contracts, taken together, do not constitute a plan. FAS 106 provides guidance on the accounting for postretirement benefits that are part of a plan for retirees, but are not part of a pension plan.

6. APB 12 requires deferred compensation costs to be recognized over the service period in a systematic and rational manner. At the end of the service period (the full eligibility date as defined in FAS 106[1]), the accrued amount should equal the then present value of the benefits expected to be provided to the employee and the employee's beneficiaries. For example, future payments, including death benefits, to be paid to the employee and the employee's beneficiaries should be accrued over the service period such that a liability at the end of the service period exists in the amount of the present value of those payments.

7. Under FAS 106, an employer should recognize and measure the obligation for postretirement benefits based on the actuarial present value of all future benefits attributed to an employee's service rendered to that date. FAS 106 requires an employer to attribute the costs of those postretirement benefits over the required service period.

Diversity in Practice

8. The FASB staff does not believe that there is diversity in practice in accounting for arrangements that are in substance collateral assignment split-dollar policies (as described

[1] FAS 106 defines *full eligibility date* as "the date at which the employee has rendered all the service necessary to have earned the right to receive all of the benefits expected to be received by that employee (including any beneficiaries and dependents expected to receive benefits)."

above). Similarly, there does not appear to be diversity in practice related to split-dollar life insurance arrangements whereby the employer is the primary obligor for the death benefit. In those situations, the employer has contractually promised the employee a specified postretirement death benefit and has funded this obligation through an endorsement split-dollar life insurance policy. In the event that the insurance company is unable to pay its obligation under the insurance policy (for example, due to insolvency) the employer is legally obligated to pay the employee's beneficiaries. The FASB staff has been informed that the postretirement benefit obligation is typically accounted for in practice under either APB 12 or FAS 106 (depending on whether a plan is deemed to exist.)

9. Since there does not appear to be diversity in practice in accounting for the aforementioned split-dollar life insurance policies, this Issue Summary Supplement will not address those types of arrangements. For typical endorsement split-dollar arrangements (that is, the type of arrangement described above in the background section), however, there appears to be diversity in practice in accounting for the deferred compensation and postretirement aspects of such plans. Some believe that APB 12 or FAS 106 (if the arrangement is part of a plan, FAS 106 would be applicable, and APB 12 would be applicable otherwise) should be applied and that a liability for the postretirement benefit obligation should be recognized. However, some believe that the employer's obligation to provide the death benefit is effectively settled when the insurance policy is purchased and that, therefore, no liability for the future benefit should be recognized.

Previous Task Force Discussion

10. At the March 16, 2006 EITF meeting, the Task Force was unable to reach a consensus on the issue of whether a liability should be recognized for the deferred compensation and postretirement benefit aspects of a typical endorsement split-dollar life insurance arrangement. At that meeting, however, Task Force members acknowledged that for a typical endorsement split-dollar life insurance arrangement, an employer has provided an employee with a postretirement benefit that is within the scope of FAS 106 (or APB 12 if the arrangement does not constitute a plan). FAS 106 defines a postretirement benefit as follows:

> All forms of benefits, other than retirement income, provided by an employer to retirees. Those benefits may be defined in terms of specified benefits, such as

> health care, tuition assistance, or legal services, that are provided to retirees as the need for those benefits arises, such as certain health care benefits, or they may be defined in terms of monetary amounts that become payable on the occurrence of a specified event, such as life insurance benefits.

11. The Task Force disagreed, however, on whether the employer should record a liability for the obligation associated with the postretirement benefit that is being provided. Certain Task Force members believed that while a postretirement benefit has been provided in accordance with FAS 106 or APB 12, the purchase of the split-dollar life insurance policy effectively settles this obligation.

Scope

12. The scope of this Issue is limited to the recognition of a liability and related compensation costs for endorsement split-dollar life insurance policies (as described above in the background section) that provide a benefit to an employee that extends to postretirement or post-employment periods. Therefore, this Issue would not apply to a split-dollar life insurance arrangement that provides a specified benefit to an employee that is limited to their active service period with an employer.

Accounting Issue and Alternatives

Issue: Whether the postretirement benefit associated with an endorsement split-dollar life insurance arrangement is effectively settled in accordance with either FAS 106 or APB 12 upon entering into such an arrangement.

View A: An employer should recognize a liability for future benefits based on the substantive agreement with the employee, since the postretirement benefit obligation is not effectively settled. For example, if the arrangement is to provide the employee with a death benefit, the employer should recognize a liability for the future death benefit in accordance with either FAS 106 or APB 12 (depending on whether the arrangement is considered a "plan" in accordance with FAS 106).

13. Proponents of View A believe that entering into an endorsement split-dollar life insurance arrangement with an employee is a postretirement benefit that must be accounted for in

accordance with FAS 106 or APB 12. Proponents of View A refer to paragraph 163 of FAS 106, which states, in part, "The Board concluded that the obligation to provide postretirement benefits meets the definition of a liability…." Therefore, the Board decided that if an employer has incurred an obligation to provide postretirement benefits, then it must record a liability. These proponents further note that once a postretirement benefit obligation has been incurred by an employer it may only be relieved through a *settlement*, which is defined in the Glossary of FAS 106 as follows:

> An **irrevocable** action that relieves the employer (or the plan) of primary responsibility for a postretirement benefit obligation and **eliminates significant risks related to the obligation and the assets used to effect the settlement**. Examples of transactions that constitute a settlement include (a) making lump-sum cash payments to plan participants in exchange for their rights to receive specified postretirement benefits and (b) purchasing **nonparticipating insurance contracts** for the **accumulated** postretirement benefit obligation for some or all of the plan participants. [Emphasis added.]

14. Proponents of View A believe that purchasing a typical endorsement split-dollar life insurance policy does not qualify as a settlement under FAS 106. Paragraphs 67-71 of FAS 106 and the definition of settlement above indicate that purchasing *nonparticipating* insurance contracts can qualify as a settlement if certain criteria are met.

15. The FASB staff has been informed that a significant majority of endorsement split-dollar life insurance arrangements are structured as universal life policies. As such, the insurer generally has the right to recover unexpected increases in the cost of insurance due to changes in mortality or increased administrative costs. For example, if the policy is structured as a single premium policy, the insurer will either bill the owner of the policy directly for this amount or deduct it from the cash surrender value of the policy. Proponents of View A believe that universal life policies would not qualify as *nonparticipating* insurance contracts under FAS 106. They believe that these are actually participating insurance policies, which are defined in the glossary of FAS 106, as follows:

> An insurance contract that provides for the purchaser to participate in the investment performance and possibly other experience (for example, morbidity experience) of the insurance company.

16. Proponents of View A believe that the Board's intent in FAS 106 is that if an owner of a policy is exposed to experience losses of the insurer, then a settlement has not occurred. They refer to paragraph 373 of FAS 106, which states, in part:

> The Board also is aware that some participating contracts may require or permit payment of additional premiums if experience is unfavorable. The Board concluded that if a participating contract requires or permits payment of additional premiums because of experience losses, or if the substance of the contract is such that the purchaser retains all or most of the related risks and rewards, the purchase of that contract does not constitute a settlement.

17. Additionally, these proponents point to a number of other factors as evidence that the liability has not been settled. These factors include, but are not limited to:

a. ***Irrevocability***—*Irrevocable* is defined by *Black's Law Dictionary*, Seventh Edition, as "unalterable, committed beyond recall." However, an employer can either outright cancel these types of arrangements or switch to a different insurance carrier. Therefore, it does not appear that an employer has entered into an irrevocable arrangement.

b. The employer is the owner and part beneficiary of the policy and therefore has not transferred most of the risks and rewards associated with the assets used to effect the settlement. That is, the employer records an asset for the cash surrender value of the policy (depending on the policy's structure) and will receive a portion of the death benefit upon the death of the covered employee. By recognizing this asset, the employer is demonstrating that it is sharing in the benefits of the insurance arrangement. Additionally, the employer remains subject to the risks related to the assets used to effect the settlement, since if the insurance company were to default on the policy the company would not recover the cash surrender value.

c. In order to settle an *accumulated* postretirement benefit obligation, a liability would need to have been already recognized. That is, because no benefits have accumulated at the date the policy is entered into, the arrangement represents a pre-funding of the postretirement benefit, rather than a settlement. Proponents believe that the pre-funding should not impact the recognition of the liability and refer to paragraph 150 of FAS 106, which states, in part:

> The decision of how or when to fund the obligation is not an accounting issue. It is a financing decision that is properly influenced by many factors (such as tax considerations and the availability of attractive investment alternatives) that are unrelated to how or when the postretirement benefit obligation is incurred.

18. Under these arrangements, proponents believe that the employer has clearly given value to the employee in the form of a postretirement benefit. For example, the company could have derived additional value (that is, received the entire death benefit) by purchasing a key-man life insurance policy. These proponents believe that by entering into the endorsement split-dollar arrangement with the employee, the employer is providing benefits to the employee that the employer would otherwise have been entitled to and, therefore, has sacrificed the right to future economic benefits.[2]

View B: An employer should not recognize a liability for future benefits or premiums because the purchase of the endorsement split-dollar life insurance policy effectively settles the obligation.

19. Proponents of View B believe that for a typical endorsement split-dollar arrangement (as described in the background section), all of the risks of providing a death benefit to an employee have been transferred to the insurance company. Therefore, the employer has effectively settled its obligation with the employee and should not be required to recognize a liability for postretirement benefits. These proponents believe that recognizing an obligation for this postretirement benefit would be inconsistent with the characteristics of a liability described in paragraph 36 of CON 6, which states:

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence

[2] Paragraph 35 of CON 6 defines liabilities as "probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as the result of past transactions or events" (footnote references omitted).

> of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

20. Proponents of View B note that in the typical endorsement split-dollar life insurance arrangement an employer has no obligation to fund the death benefit. This benefit will be paid by the insurance company and, therefore, the employer will not sacrifice any future assets after the premiums are paid under the policy. For example, should the insurance company fail to fulfill its obligation under the insurance policy, the employer is under no legal obligation to pay for the benefit that would otherwise have been paid by the insurance company. Accordingly, they do not believe that the obligation described in View A satisfies either characteristic (a) or characteristic (b), above, for purposes of recognizing a liability.

21. Proponents of View B further note that if an employer were to purchase insurance contracts to cover postretirement benefits, the benefits covered by these contracts should be excluded from the accumulated postretirement benefit obligation. Specifically, paragraph 67 of FAS 106 states, in part:

> For purposes of this Statement, an insurance contract is defined as a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium; an insurance contract is **irrevocable** and involves the transfer of significant risk from the employer (or the plan) to the insurance company. Benefits covered by insurance contracts shall be excluded from the accumulated postretirement benefit obligation. [Footnote reference omitted and emphasis added.]

22. Proponents of View B believe that for purposes of determining whether or not a settlement has occurred, irrevocability must be assessed from the insurer's perspective. That is, has the insurance company undertaken the legal obligation to provide the specified benefits to the employee. They argue that as long as the employer continues to pay the premiums under the policy, the insurance company may not revoke this policy. Additionally, they note that if irrevocability must be assessed from the employer's perspective, then very few, if any, policies would qualify as an insurance contract under FAS 106, since almost all policies can be cancelled by the owner of the policy. They do not believe that this was the Board's intent, and refer to

paragraph 366 of FAS 106, which explicitly describes a type of policy that would qualify as follows:

> However, some insurance contracts, such as single-premium, nonparticipating life insurance contracts, do effectively transfer the primary obligation for payment of benefits from the employer (or the plan) to the insurance company. In those circumstances, the premium paid for the benefits attributed to the current period is an appropriate measure of postretirement benefit cost for that period. The Board concluded that the purchase of a nonparticipating insurance contract is a settlement of a postretirement benefit obligation rather than an investment.

23. Proponents note that many endorsement split-dollar life insurance arrangements are structured as single premium payments and, therefore, would be analogous to the above situation and qualify as insurance contracts.

24. Opponents counter that with the sentence that precedes the above guidance in paragraph 366 of FAS 106, which states:

> The Board recognizes that, except for single-premium life insurance contracts, there are few, if any, contracts at the present time that unconditionally obligate an insurance company to provide most forms of postretirement benefits.

25. Opponents believe that this excerpt helps to illustrate that the Board does not believe that it would be common for an employer to be able to purchase an insurance product that effectively settles a postretirement benefit. They believe that the single premium policy described above relates to a policy purchased for an employee whereby the employee is both the owner and beneficiary of the policy. In that situation, the arrangement would be irrevocable since the employer could not cancel the policy and the employer would not retain any risks and rewards related to the assets used to effect the settlement. Additionally, opponents believe that the purchase of these types of policies represent purchases of participating insurance contracts that do not qualify for settlement accounting under FAS 106 (see View A).

26. Finally, proponents of View B do not believe that the accounting consequence of reporting a liability for postretirement benefits for an endorsement split-dollar life insurance arrangement results in meaningful financial reporting. For example, they do not believe that an employer

should have to record a liability for an amount in which cash will never be expended and then ultimately reverse that amount as a gain upon the death of the insured or when the employee retires and becomes entitled to the benefit (see Exhibit 06-4A for illustrative journal entries).

International Convergence

27. Endorsement split-dollar life insurance arrangements as described in this Issue Summary Supplement are within the scope of IAS 19. The language in IAS 19 is sufficiently different from that of FAS 106, and, therefore, any consensus reached herein may not necessarily provide guidance for entities that report under IFRS. The IASB staff has indicated that it has not encountered arrangements that are similar to endorsement split-dollar life insurance policies.

Effective Date and Transition

28. As indicated above, diversity in practice currently exists in accounting for endorsement split-dollar life insurance arrangements. Accordingly, the FASB staff believes that the Task Force should consider transition alternatives for any consensus reached on these issues. The staff has identified the following transition alternatives.

Alternative A

The guidance in this consensus shall be effective for fiscal years beginning after the date that the consensus is ratified. An employer shall report this as a change in accounting principle through retrospective application to all prior periods. This should include the recognition of:

a. The cumulative effect of the change to the new accounting principle on periods prior to those presented reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented
b. An offsetting adjustment, if any, made to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that period
c. Financial statements for each individual prior period presented shall be adjusted to reflect the period-specific effects of applying the new accounting principle.

The following would be disclosed:

a. A description of the prior-period information that has been retrospectively adjusted, if any
b. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for any prior periods retrospectively adjusted.
c. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the earliest period presented.

29. Opponents to retrospective application believe that such transition would be impractical to apply. These opponents believe that it would be difficult to recreate assumptions that would have been used and that determining the effect in each of the prior comparative periods presented would require a substantial effort.

Alternative B

The guidance in this consensus shall be effective for fiscal years beginning after the date that the consensus is ratified. The effect of initially applying this guidance should be accounted for in a manner similar to a cumulative-effect-type adjustment. Thus, financial statements for prior years should be presented as previously reported, and the cumulative effect, if any, of adopting the guidance on the amount of retained earnings (or other appropriate components of equity or net assets) at the beginning of the period in which this guidance is first applied should be included in the opening balance of retained earnings (or other appropriate components of equity or net assets) in the period of the change.

Presentation of per-share amounts for the cumulative effect shall be made either on the face of the income statement or in the related notes.

Alternative C

Assuming a View A consensus, the guidance in this consensus shall be effective for fiscal years beginning after the date that the consensus is ratified, and the difference between the accumulated benefit obligation at the beginning of that year and any amount accrued that is associated with these arrangements would be recognized over the average remaining service period of the employees who are expected to receive benefits under the plan.

Exhibit 06-4A

ILLUSTRATION OF JOURNAL ENTRIES FOR A HYPOTHETICAL ENDORSEMENT SPLIT-DOLLAR LIFE INSURANCE ARRANGEMENT

A typical endorsement split-dollar life insurance arrangement provides the employee with a death benefit both during active employment and postretirement (once the employee has provided the requisite service to have earned the benefit). Due to the defined scope of this issue, the following simplified example assumes that the employee only receives the benefit during postretirement. For simplicity, it assumes that the cash surrender value and postretirement benefit obligation accrue ratably throughout the service period.

Facts

Employer enters into an endorsement split-dollar life insurance arrangement with an employee, currently 52 years old, that will provide $100,000 of life insurance to the employee in postretirement periods once the employee provides 10 years of service (mandatory retirement age is 62). Additional features of the policy are as follows:

- Face amount of policy is $500,000
- Employer pays a single premium of $100,000 on the date the employee turns 52 years of age
- The employer is the owner of the policy and is entitled to 100 percent of the cash surrender value and any amounts in excess of the employee's specified death benefit
- The employer can cancel coverage at any time
- The employer has no legal obligation to pay the employee's beneficiary the specified death benefit should the insurer default under its obligation
- Assume that the cash surrender value increases $5,000 per year
- Assume that the actuarial present value of the postretirement benefit to be recognized per year is $6,000
- Assume the employee dies one day following attaining 62 years of age.

Journal Entries	**Debit**	**Credit**
Day 1		
Insurance Asset	100,000	
Cash		100,000

(To record the purchase of the endorsement split-dollar life insurance arrangement – assume that the cash surrender value equals premium payment)

End of year 1

Deferred compensation expense	6,000	
Postretirement benefit obligation		6,000

(To record the postretirement benefit obligation for the year – this same entry would be recorded each year until age 62, the full eligibility date)

Insurance asset	5,000	
Investment income		5,000

(To recognize the increase in the cash surrender value of the policy – this would continue until the earlier of the employee's death or surrendering of the policy)

End of Year 10 – Full Eligibility and Employee Death

Postretirement benefit obligation	60,000	
Deferred compensation expense		60,000

(To record the settlement of the postretirement benefit obligation upon death of the employee)

Cash	400,000	
Insurance asset		150,000
Gain		250,000

(To record gain on insurance proceeds)