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LETTER OF COMMENT NO.

94

Re: EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

### **FAS 106 & BOLI Death Benefits to Employees**

Meyer-Chatfield is a National Consulting firm, specializing in assisting Banks as they implement Bank Owned Life Insurance (BOLI) transactions. These transactions, as will be explained in more detail below, involve an Employer (Bank) purchasing Life Insurance policies on selected employees. It is a common practice in these transactions for the Bank to share a portion of the Death Benefits payable upon the insured employee's death with the insured employee's beneficiary. The current accounting environment is inconsistent as to proper accounting where this Death Benefit is still payable to the employee post retirement. Most auditors will not require an accrual under FAS 106, however, some do. Post Sarbanes-Oxley, at least one National accounting firm has changed its position, causing new accruals for plans already in existence.

It is an inescapable truth that the type of benefit sharing outlined below does not, cannot and will not result in any financial exposure or risk to the assets of the sponsoring Bank. Consequently, we offer these comments in support of an accounting position which reflects the facts of the transaction, and would negate any pre-retirement liability where the funding of the policy is in place.

### **SECTION ONE**

#### Bank-Owned Life Insurance

Bank-Owned Life Insurance (BOLI) is a highly specialized type of life insurance that typically involves a single premium, no load, modified endowment life insurance contract. A typical BOLI contract illustration is shown in exhibit A to this memorandum.

In this illustration, there are two elements of a BOLI contract that can create profit for a bank owner. The first element of profitability is the cash value growth in excess of premiums paid. High-end BOLI contracts will typically yield 25 to 35 basis points over the five-year treasury as a cash value accumulation yield. Since there are no loads or surrender costs upon a surrender, this growth is accounted for as credited. The second element of profitability comes about when the insured dies. At the death of the insured, while the cash value of the asset would be written off, since the contract no longer exists, the corresponding receipt of cash typically far exceeds the

cash value of the assets in all years. This difference between cash value and death benefit is mandated by Internal Revenue Code §7702 and is typically referred to as the "at risk" or "corridor" amount. It is not acceptable for a purchaser of life insurance to currently account as any kind of an asset or receivable, the death benefit element of the life insurance contract, hence the receipt of this is recorded as a gain at the death of the insured. Accounting for life insurance is mandated by FASB technical bulletin 85-4, which specifies that cash surrender values, which are receivable upon surrender (i.e. net of any surrender charges or loads), are carried as an asset. Annual increases to the asset are booked as income and upon death, death proceeds are cash receipts with corresponding credits to cash value and income to balance the transaction. BOLI contracts rarely, if ever, have surrender charges, so the full cash value is reflective of the bookable asset under 85-4.

One aspect of BOLI is that many banks choose not to "profit" from the death of the employee. Consequently, such banking institutions would allow the employee to have rights to the death benefit portion of the contract with the bank retaining all rights to the cash value component of the contract.

There are two contractual methods utilized by employers to implement the employee benefit. These are outlined below.

### ***Method 1***

#### **Endorsement Split Dollar**

One manner by which such sharing of death benefits with the employee is accomplished, is via an "endorsement" split-dollar agreement. It is typical in these agreements to provide that for as long as the life insurance contract is in force, the insurance company will pay to the employee's named beneficiary a specified death benefit amount. The insurance company will then pay the balance, net of such specified or formula driven death benefit amounts, to the corporation. It is also typical in such split-dollar arrangements to specifically state that if the contract of insurance is surrendered by the bank at any time, the benefit to the employee is no longer payable. Such benefits to employees customarily continue beyond retirement age, hence, the potential applicability of FAS 106 to the transaction. Finally, under numerous IRS revenue rulings, it is required that employees recognize imputed income for the economic value of the life insurance benefit granted them, and this imputed income is required both pre and post retirement. Avoidance of imputed income is achieved by having employees pay the appropriate term cost associated with their portion of the insurance benefit each year.

### ***Method 2***

#### **Death Benefit Only (DBO)**

A second type of structure, whereby BOLI death benefits can be shared with employees, is via a "Death Benefit Only" or DBO arrangement. Utilizing this design, all insurance

proceeds are received by the employer tax free. The employer then makes a stipulated payment or series of payments to the employees' beneficiary. These payments are tax deductible to the employer and taxable to the recipient. Usually, if the intent is to share \$100,000 of the death proceeds, the entire DBO payment to the beneficiary would be \$150,000 to allow for the tax consequence. One significant advantage of the DBO arrangement is that there is no annual imputed taxable income to the employee.

As in the Endorsement Split Dollar arrangement, the agreement which grants the benefit references the supporting life insurance contract. If for any reason the life insurance contract is surrendered or benefits not paid (i.e., the death occurs during the contestable period and the carrier is successful in advancing a material misstatement claim), there is no obligation to the employee's beneficiary.

As with the Endorsement Split Dollar arrangement, the employer has effectively shifted the responsibility for the DBO benefits to the insurance carrier, only using the employer as a conduit for payment, and avoiding for the employee the necessity of additional taxable income each year the benefit is in place.

#### **Summary of the transaction:**

The company purchases a single premium, paid-up life insurance policy. The life insurance policy produces profit for the company from two sources. The first source of profit is the increases to cash surrender value, which are fully accounted for currently under FAS Technical Bulletin 85-4. The second source of profit comes from the corridor or at risk amounts payable at the death of the insured, above and beyond cash value, which is payable upon, and accounted for upon, the death of the insured. No accounting for these amounts is permissible until received. This "unreflected gain" provides the means of settlement with the employee. Upon the death of an employee, a portion of the death proceeds will either be paid to the named beneficiary of the employee, with the balance of the proceeds payable to the corporation, or the corporation will act as a conduit to pay the stipulated amount to the employees' beneficiary. The payment amount cannot exceed the gain at death. The gain in the policy brought about by the death of the insured is accounted for at time of death while the cash value portion of the transaction is accounted for as it is earned. The structure of the plan whereby death benefits are shared with employees is designed so that any cash values accrued by the corporation prior to time of death can not be jeopardized in any way by the death benefit element shared with the named employee's beneficiary. The employee portion is always funded by the "at risk" portion of the policy. The contract governing the benefit, specifies that the benefit to the employees' beneficiary is contingent on the life insurance policy being in force, and the amount payable cannot exceed the "at risk" amount payable by the carrier at the death of the employee.

#### **Discussion:**

Current accounting practice is extremely inconsistent with most accounting firms recognizing that by inferring from Paragraphs 67, 90, 366, 368, and 372 of FAS 106 the referenced settlement accounting. Other firms follow a literal reading of paragraph 63 that insurance contracts are not plan assets and no offset rights exist.

Our clients recognize that it is beneficial, and helps with any perceived reputation risk, to share the benefits of the BOLI transaction directly with the insured employees. However, if there is a requirement to accrue pre-retirement the costs of the post-retirement benefit, even when this is pre-paid through the insurance arrangement, in almost all circumstances the post-retirement benefit is not provided. This is detrimental to the employee's family. In our view, to no purpose.

Where settlement accounting is allowed, no accruals at retirement date are necessary. Where settlement accounting is not allowed, substantial accruals are necessary, to the detriment of the plan. These accruals would be reversed upon actual death, as the insurance proceeds "settle" the obligation. This, of course, results in substantial earnings skewing.

If the documentation and insurance structure eliminates any risk to recorded Bank assets, there should inescapably follow a conclusion that the accounting procedures allow a "Settlement" option and not require an accrual.

It is our position that this inconsistency be addressed by the FASB and rectified clearly to permit, where facts support it, a right of settlement accounting, to facilitate continued sharing of death proceeds with insured employee's families post-retirement. This facilitates a sound business practice and will be to the benefit of many employees.