FASB Emerging Issues Task Force

Issue No. 06-10

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

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Previously distributed EITF materials: None

References:

FASB Statement No. 5, *Accounting for Contingencies* (FAS 5)

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

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

FASB Special Report, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*: *Questions and Answers* (Q&A #9)

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

APB Opinion No. 21, *Interest on Receivables and Payables* (APB 21)

AICPA Statement of Position 96-1, *Environmental Remediation Liabilities* (SOP 96-1)

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* **The alternative views presented in this Issue Summary 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 for public comment, and it is ratified by the Board.**

AICPA Issues Paper, *Accounting for Key-Person Life Insurance*, dated October 31, 1984 (AICPA Issues Paper)

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

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

EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance* (Issue 06-5)

Background

1. At the September 7, 2006 EITF meeting, the Task Force reached a consensus on Issue 06-4, that for an endorsement split-dollar life insurance arrangement, an employer should recognize a liability for future benefits in accordance with FAS 106 (if, in substance, a postretirement benefit plan exists) or APB 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive agreement with the employee. At the June 15, 2006 EITF meeting, a Task Force member requested that the staff research, for consideration by the EITF Agenda Committee, whether the conclusions reached on Issue 06-4 should also apply to collateral assignment types of arrangements. At the October 11, 2006 EITF Agenda Committee meeting, the Committee added this Issue to the EITF agenda.

2. 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. The two most common types of arrangements are endorsement split-dollar life insurance arrangements and collateral assignment split-dollar life insurance arrangements. Generally, the difference between these arrangements is dependent upon the ownership and control of the life insurance policy. In an endorsement split-dollar life insurance arrangement, the company owns and controls the insurance policy, whereas in a collateral assignment split-dollar life insurance arrangement, the employee (or the employee's estate or a trust controlled by the employee, collectively the "employee") owns and controls the insurance policy. The examples discussed below describe the terms of a typical collateral assignment split-dollar life insurance arrangement[1] (refer to Issue 06-4 for the terms of a typical endorsement split-dollar life insurance arrangement):

> An employee purchases a life insurance policy through an arrangement with the employer to insure the employee's life and/or the life of the employee's spouse. In other circumstances, the employer purchases a life insurance policy and transfers ownership of the insurance policy to the employee. In either case, the employee owns the insurance policy and controls all rights of ownership. The employer usually pays all or a substantial part of the premium.

[1] An example arrangement has been provided to facilitate the discussion of this Issue. However, these arrangements are tailored specifically to each employer and, as such, the arrangements can vary significantly.

The employee irrevocably assigns a portion or all of the death benefits to the employer as collateral for the employer's interest in the insurance policy (the collateral assignment arrangement). 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 premiums paid plus an additional fixed or variable return on those premiums. Upon retirement, the employee may have an option or be required to buy the employer's interest in the insurance policy or transfer the insurance policy to the employer in satisfaction of the outstanding loan.

3. The FASB staff understands that two key factors have diminished the use of the collateral assignment split-dollar arrangement. The first factor is as a result of the Internal Revenue Service (IRS) issuance of several notices and regulations between 2001 and 2003 that targeted equity[2] split-dollar arrangements. While endorsement and collateral assignment split-dollar arrangements can be either equity arrangements or non-equity arrangements, the regulations specifically addressed collateral assignment arrangements in which the life insurance policy collateralized the premiums paid (the employee loan). Collateral assignment split-dollar arrangements were now subject to complicated tax regulations that significantly reduced (if not completely eliminated) the tax advantages of these arrangements. The second factor was the introduction of the Sarbanes Oxley Act of 2002 (the Act) (for both public and private entities). Many entities have discontinued these programs since these arrangements are considered to be employee loans, which are expressly prohibited under the Act. Entities that continue to maintain these arrangements typically account for them as employee loans and apply the provisions of APB 21. Accordingly, an employer would record a receivable from the employee at a discounted amount for the premiums paid.

4. During the research and analysis of Issue 06-4, the FASB staff asserted that there was no diversity in practice concerning collateral assignment split-dollar arrangements, especially in light of the requirements of the Act, which significantly reduced the marketability of this arrangement. However, the consensus reached in Issue 06-4 only applied to endorsement split-

[2] *Equity* refers to the excess of cash surrender value over the amount contractually due the employer (for example, premiums paid) pursuant to the collateral assignment agreement. The IRS was mainly concerned with the owner of the equity and the timing of the taxation of this amount.

dollar arrangements and not collateral assignment split-dollar arrangements. While the IRS regulations significantly reduced new issuances of the equity type of arrangement, the non-equity type of arrangement could still be utilized. In fact, the non-equity collateral assignment split-dollar arrangement functions in a manner (from a taxation perspective) similar to a non-equity endorsement split-dollar arrangement. Since Issue 06-4 created diversity for the recognition of the postretirement obligation between endorsement and collateral assignment arrangements, entities may have an opportunity to structure collateral assignment split-dollar arrangements with a postretirement benefit obligation that does not require separate accounting recognition. The issue to be addressed in this Issue Summary is whether or not a collateral assignment split-dollar arrangement should record a postretirement benefit obligation based on the terms of the arrangement similar to the conclusion reached on an endorsement split-dollar arrangement pursuant to Issue 06-4.

5. During the EITF Agenda Committee meeting, an Agenda Committee member questioned the accounting recognition of the asset (employee loan) by the employer in a collateral assignment split-dollar arrangement. As previously discussed, employers that maintain these arrangements consistently account for them as employee loans and apply APB 21. In situations in which an employee surrenders an insurance policy and the cash surrender value is not sufficient to repay the loan to the employer, the present value of the loan may not represent the realizable value of the asset. This situation is addressed in Issue 2.

Scope

6. The scope of this Issue is limited to the recognition of the asset, the liability, and the related compensation costs for collateral assignment split-dollar life insurance arrangements (as described in the background section) that provide a benefit to an employee that extends into postretirement periods. Therefore, this Issue would not apply to a collateral assignment split-dollar life insurance arrangement that provides a specified benefit to an employee that is limited to that employee's active service period with an employer.

Accounting Issue and Alternatives

Issue 1: Whether an entity should record a liability for the postretirement benefit associated with a collateral assignment split-dollar life insurance arrangement in accordance with either FAS 106 or APB 12.

View A: An employer should <u>*not*</u> *recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement.*

7. View A proponents believe that a collateral assignment arrangement is substantively different from an endorsement arrangement and, therefore, the accounting recognition should not be the same as the conclusions reached in Issue 06-4. For example, as discussed by the Task Force in Issue 06-4, under an endorsement split-dollar life insurance arrangement, the employer owns and controls the insurance policy and also remains subject to the positive and negative experience of the insurance company. Therefore, a settlement of the benefit promised to the employee has not occurred. Under a collateral assignment arrangement, View A proponents point out that even if a death benefit reflects the substantive agreement with the employee (and View A proponents believe this to be rare), an obligation would not have to be recorded since the insurance policy would effectively settle the postretirement benefit obligation in accordance with FAS 106 or APB 12. That is, the purchase of the insurance policy is irrevocable (the employer cannot cancel the insurance policy) and the employee, not the employer, is subject to the positive and negative experiences with the insurance company.

View B: An employer should recognize a liability for the postretirement benefit related to a collateral assignment split-dollar life insurance arrangement in accordance with either FAS 106 or APB 12.

8. View B proponents believe that there is no economic difference between an endorsement split-dollar life insurance arrangement and a collateral assignment split-dollar life insurance arrangement and, therefore, the accounting should be the same. For example, they note that in either case, both the employer and the employee will receive the same benefit, which may be in the form of a death benefit or an agreement to maintain the premiums of the insurance policy in

the postretirement period. Furthermore, under the collateral assignment arrangement, the employee promises to purchase the insurance policy with the proceeds of the loan. The fact that this is a legally enforceable aspect of the arrangement and the employees are compelled to agree to it when they sign the arrangement makes the purchase of the insurance policy by the employee not a matter of choice. Therefore, even though the insurance policy is owned by the employee, the employer provides the benefit, the means to purchase the benefit, and the means to ensure that the intended benefit is purchased (through its legal rights).

9. View B proponents also believe that similar to an endorsement split-dollar life insurance arrangement, the employer remains subject to the positive and negative experiences of the insurance company. That is, the employer is obligated to pay the premium under the arrangement and if the employee were to default under its "loan" with the employer, the cash surrender value may not be sufficient to cover the premiums paid. Accordingly, proponents of View B believe that similar to the consensus reached by the Task Force in Issue 06-4, the postretirement obligation would not be settled in accordance with either FAS 106 or APB 12. Opponents of View B point out that under some collateral assignment arrangements, the employer has certain rights that should the employee default on the loan, the employer would be able to enforce its right for repayment and obtain the insurance policy (through a transfer of the employee's interest in the insurance policy under the arrangement). At this point, the employer no longer has an obligation to the employee under the collateral assignment arrangement and is able to recover the loan amount by holding onto the insurance policy (and recovering the loan amount either as the cash surrender value increases or with the death of the employee).

10. Proponents of View B believe that the difference between an endorsement arrangement and a collateral assignment arrangement arises from their tax implications. The choice of one type of arrangement over another is merely to facilitate the execution of a tax strategy and is not based on a substantive difference in the benefit provided. Both types of arrangements use the same types of insurance policies. The insurance policies used are generally not annuity insurance contracts. Therefore, pursuant to FAS 106, settlement of a postretirement obligation cannot be achieved.

The staff emphasizes that this Issue is not intended to redeliberate the consensus in Issue 06-4, that is, pursuant to Issue 06-4, an employer should recognize a liability for future benefits in accordance with FAS 106 (if, in substance, a postretirement benefit plan exists) or APB 12 (if the arrangement is, in substance, an individual deferred compensation contract) based on the substantive arrangement with the employee. The Issue, in this instance, is whether a collateral assignment split-dollar arrangement that contains postretirement benefits should be accounted for in a manner consistent with the consensus reached in Issue 06-4 for endorsement split-dollar arrangements.

Issue 2: How an employer should recognize and measure the asset in a collateral assignment split-dollar life insurance arrangement.

View A: An employer should recognize an asset based on the cash surrender value of the underlying insurance policy related to the collateral assignment split-dollar life insurance arrangement.

11. Proponents of View A believe that endorsement split-dollar arrangements and collateral assignment split-dollar arrangements are economically similar transactions and, therefore, should be accounted for in a consistent manner. They also believe that the cash surrender value should be the basis for asset recognition since it will be used in all cases (except in death) to repay the loan. Finally, proponents of View A point out that in many of these arrangements, the amount due back to the employer is often limited to the cash surrender value on the employee's insurance policy, which is used to collateralize the premiums to the employer. That is, the employer may continue to pay premiums but at some point, the cumulative premiums paid may exceed the cash surrender value on the employees' insurance policy. In this instance, recording an amount due from the employee based on the premiums paid may exceed the amount that is required to be repaid under the collateral assignment arrangement. Therefore, proponents of View A believe that the cash surrender value (adjusted for any agreements separate from the insurance policy) should be recorded.

12. Opponents of View A counter that requiring the cash surrender value to be recorded may not represent the substance of the arrangement. In instances in which the collateral assignment arrangement requires repayment of an amount that is different from the cash surrender value (for example, the loan represents only the premium paid by the employer), the cash surrender value may exceed the actual loan amount under the arrangement, which could distort the employer's financial statements. CON 6 defines assets as "probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events." Opponents of View A point out that when the contractual amount due back to the employer is other than the cash surrender value, the cash surrender value is not a probable future economic benefit and has not been obtained or controlled by the employer through past transactions (and thus does not meet the definition of an asset).

View B: An employer should recognize an asset based on the loan receivable related to the collateral assignment split-dollar life insurance arrangement discounted pursuant to APB 21.

13. Proponents of View B believe that to the employer, the asset is a loan. Therefore, they believe that the asset should be recognized based on the present value of the loan pursuant to APB 21. Proponents of View B believe that the means by which the employee repays the loan are not relevant to the employer since the employer has a legally enforceable agreement with the employee that stipulates the amount that has been loaned and the repayment terms.

14. Opponents of View B believe that the recognition of the asset as a discounted loan receivable does not fully represent the economics of the arrangement. Rather, they believe an appropriate measure would not only discount the loan receivable, but also incorporate expectations related to the employee surrendering the insurance policy (for example, expectations related to the employee leaving the employer, the employee's ability to pay back the loan, and the employee's expected date of death). Therefore, opponents of View B believe any measurement of the asset that does not incorporate all expectations is not a representationally faithful measurement of that asset.

View C: An employer should recognize an asset based on the terms of the collateral assignment split-dollar life insurance arrangement.

15. Proponents of View C believe that the asset should be measured in a manner consistent with the terms of the collateral assignment arrangement. Since there are numerous contractual variations among collateral assignment split-dollar arrangements, View C proponents believe requiring a measurement attribute is inappropriate and would lead to an inaccurate measurement of the asset in certain circumstances. For example, a collateral assignment arrangement may stipulate that the employer is legally required payment from the employee (or the employee's estate) of the premiums paid by the employer with interest. If a decision on this Issue were reached such that the asset is measured based on the cash surrender value (View A), the asset could be overstated (at least in the early years). In another example, a collateral assignment arrangement may stipulate that the employee or the employee's estate must pay the employer the cash surrender value at termination of employment or death, respectively. If a decision on this Issue were reached such that the asset is measured in accordance with APB 21 (View B), the asset may be understated (at least in the early years). Therefore, proponents of View C believe the diversity in the terms of these arrangements requires a measurement attribute that reflects the nature of the arrangement between the employer and the employee based on the amount to which the employer is entitled.

16. Opponents of View C counter that allowing more than one measurement attribute for collateral assignment split-dollar arrangements will decrease comparability for arrangements that are economically similar.

View D: An employer should recognize an asset based on the fair value of the receivable related to a collateral assignment split-dollar life insurance arrangement.

17. Proponents of View D believe that the only appropriate measure is fair value. Fair value would incorporate all expectations and scenarios in relation to the repayment of the loan by the employee.

18. Opponents of View D conceptually agree with the goals of fair value, however, they point out that the Task Force had recently considered fair value in relation to the deliberations on Issue 06-5. During those deliberations, Task Force members did not believe that requesting that the FASB add a full-scale project to its agenda that would address fair value with regard to the purchase of life insurance was necessary because of the narrow application of Issue 06-5.

International Convergence

19. Collateral assignment split-dollar life insurance arrangements as described in this Issue Summary 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 collateral assignment split-dollar life insurance arrangements.

Effective Date and Transition

20. The FASB staff recommends that the transition and effective date of the consensus on this Issue should be effective for fiscal years beginning after December 15, 2007, with earlier application permitted. Entities should recognize the effects of applying the consensus in this Issue through either (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. This transition methodology is consistent with the conclusions reached by the Task Force in Issue 06-4.

21. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings, an entity should disclose the cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position.

22. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods, the entity should include the recognition of:

a. The cumulative effect of the change in 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. The cumulative effect of the change in accounting principle on retained earnings or on other components of equity or net assets in the statement of financial position
c. Adjustments to financial statements for each individual prior period presented to reflect the period-specific effects of applying the change in accounting principle.

23. If an entity chooses to apply the consensus in this Issue as a change in accounting principle through retrospective application to all prior periods, the following should be disclosed:

a. A description of the prior-period information that has been retrospectively adjusted
b. The effect of the change in accounting principle 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 caption, and any affected per-share amounts for any prior periods retrospectively adjusted
c. The cumulative effect of the change in accounting principle 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.