Article 4: Accounting Considerations, Ongoing Plan Maintenance, and Revising Existing Plans

We will close this article series with our comments on the life of a split dollar plan after implementation along with some suggestions on modifying existing plans to eliminate or mitigate some of the weaknesses we have previously detailed. In the series so far we have covered the important facets of split dollar plans up to the point of implementation. Many would consider this to be the end of the road when, in fact, it is just the beginning. While the process of designing, underwriting and implementing a split dollar arrangement can take months, the plan will more than likely be in place for decades making the need for consistent administrative support a must.

Accounting Considerations

Proper accounting for split dollar plans is based on the codification resulting from EITF [1] Issue 06-10. According to the EITF, two primary issues must be considered when determining the accounting treatment of a split dollar plan.[2]

1. Should the employer record a liability for obligations to the employee after retirement?

   This determination is based on both the explicit and implicit agreement between the employer and key employee. It is also affected by the employer's handling of similar arrangements in the past. As a result, it is important for the agreement to reflect all intentions clearly and for the parties to act in accordance with the agreement. For example, if the employer agrees to, either formally or informally, make additional premium payments in the future if the policy underperforms, a liability would probably be recorded. However, if it is evident the arrangement is settled and no further obligation by the employer exists regardless of policy performance, this liability could be avoided so long as the employer's actions are consistent.

2. How should the employer recognize and measure the asset in a split dollar arrangement?

   The answer to this question will depend on the terms of the arrangement and the rights the employer has concerning the collateral (life insurance policy). In general, the value of the asset will be the amount the employer could recover if the arrangement were to terminate at any given point in time. For example, if the employer's recovery is limited to the cash surrender value of the life insurance policy, the asset on the employer's financial statements should be that amount, adjusted at least annually. In rare circumstances, we have seen the employer's recovery rights include an amount greater than the cash value of the policy. In this case, the employer could have a case for recording the asset at a higher level.

Split dollar arrangements can have favorable accounting treatment, but employers should be diligent and consider all facts and circumstances when determining the method for recording the transaction.

Ongoing Maintenance

We recommend the employer contract with a company skilled in administering split dollar arrangements that has the information systems in place to track critical data and produce accurate and timely reports. Ideally, this would be the firm that designs and implements the plan, but not all companies have comprehensive capabilities. There are several categories of tasks that occur after the implementation of the plan. We discuss each briefly below and why they are important to both parties in the arrangement.

- *Introductory Meeting.* As part of the process of implementing a plan, we believe both the employer and key employee should have intimate knowledge of how the plan works, the assumptions made in its design and the projected results. That said, the employer should consider reviewing these details with the key employee shortly after implementation to ensure complete understanding of the most important aspects of the plan and what it is designed to accomplish.

- *Periodic Communications.* On a regular basis, relevant information should be provided to the parties, including:

[1] The Financial Accounting Standards Board's (FASB), Emerging Issues Task Force (EITF).
[2] Triscend[NP] does not provide accounting advice. Consult with your independent adviser on these matters.

- *Employer Financial Reporting.* Organizations implementing split dollar arrangements must not only record the initial funding transaction but, consistent with current accounting guidance, continue to update their financial statements to reflect changes in the plan over time. These updates should be recorded no less than annually, although most of our clients prefer to do this on a quarterly basis. It is important for the Employer to have the data necessary to make the proper entries and to ensure those entries are discussed with their tax and accounting advisers.

- *Policy Performance.* We know with certainty that actual crediting on the life insurance policy will always be different from the original projections. Because of this, one of the more important aspects of periodic reporting is the information on policy performance. Timely reporting comparing actual performance to projected performance is a big part of post-implementation service.

- *Assist with Tax Filings.* For each year in which the employer pays premiums on the policy, both the employer and employee should file a representation with their respective tax returns indicating that a "reasonable person" would expect the employer's premiums to be repaid.

  Also, if the arrangement is fully funded at implementation, the excess funds held by the insurance company will probably earn interest before being paid to the policy as premium. This interest is usually reportable to the key employee and includible in income.

- Annual Meetings. Maintaining a client's understanding of the plan is vital and reviewing the details of the arrangement during the annual meeting is designed to do just that. It is also a perfect time to update plan documents to reflect changes from the preceding year. An example of such changes would be, board composition updates, addresses, beneficiaries, and the like.

  - *Key Employee Plan Review.* On an annual basis, the split dollar plan should be reviewed from the key employee's perspective. Much of this review is centered on policy performance, particularly as it relates to the original plan. Performance should be evaluated on multiple fronts including, crediting, cash value accumulation, projected cash flow, and ability to repay the employer's premiums.

    Even though the life insurance policies may have a crediting rate that is conservative, the experience is always different than the original projections. This experience can be more or less favorable than expected but it will affect the policies nonetheless. Should underperformance persist over time, adjustments to the policy should be considered so that the policy continues to meet expectations of the employer and key employee.

  - *Employer Review.* While the key employee's perspective is valuable, the employer needs to be aware of policy performance from its perspective. Most important to the employer will be the accumulation of cash value versus projections and the maintenance of sufficient death benefit relative to its premiums paid.

Revisions to Existing Plans
Even if your split dollar arrangement has one or more of the weaknesses we have discussed as part of this series, all is not lost. Frequently, existing plans can be modified to address these issues and improve the relative positions of the organization and executive moving forward. [3]

- Policy Type. If there is concern that the existing policy lacks efficiency or crediting is too volatile, it is possible to exchange the current policy for one that is more consistent with the risk tolerances of the parties. Should this be considered, both employer and key employee should be aware of surrender and other charges and incorporate those factors into the decision process. Assuming certain conditions are met, this exchange can be accomplished on a tax-free basis.

[3] Triscend[NP] does not provide tax, accounting or legal advice. Consult your independent adviser for guidance before proceeding with any plan modifications.

- *Eliminate AFR Uncertainty.* Depending upon the terms of the plan, the AFR could be a key point of uncertainty. With AFRs near all-time lows, it could be wise for the parties to reevaluate the terms of the split dollar arrangement regarding the method used to set the interest rate.

- *Secure Employer Position.* In some circumstances, employers become concerned that the key employee's access to policy values could compromise its position and the probability it will receive a return of premiums (including interest) if applicable.

Understanding the most important factors impacting the success of a plan equips the parties to make wise decisions and structure the plan to achieve its goals with increased probability. Our purpose is to educate both nonprofit employers and executives participating in or considering participation in a split dollar plan.

Contact us for a plan review and assessment.

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