



Split-Dollar Life Insurance Technical Update January 24, 2008

Presented by Larry Brody and
Mary Ann Mancini of Bryan Cave,
and Chris Rich of RCG





Agenda

- Taxation of Split-Dollar Arrangements (SDAs):
 - Background
 - Pre-September 18, 2003 SDAs
 - ✓ Section 409A Implications
 - ✓ Planning Alternatives
- Recent Changes to Accounting for SDAs:
 - ✓ EITF 06-4
 - ✓ EITF 06-10
- Questions and Answers



Taxation of SDAs - Background

➤ Historical View:

- Revenue Rulings 64-328 and 66-110

➤ Development of Current Law:

- IRS Technical Advice Memorandum 9604001
- Notice 2001-10
- Notice 2002-8
- Final Regulations:
 - ✓ Effective for arrangements entered into after September 17, 2003
 - ✓ Loan regime
 - ✓ Economic benefit regime

➤ Sarbanes-Oxley Act:

- Prohibition of loans to Executive Officers and Directors effective July 30, 2002



Pre-September 18, 2003 SDAs

- Not covered by the 2003 split-dollar regulations.
- Covered by Notice 2002-8:
 - Value of life insurance protection:
 - ✓ Table 2001 or,
 - ✓ Insurer's lower published term rates (for pre-January 28, 2002 SDAs)
 - Optional conversion to "loan" treatment.
 - Continued use of "economic benefit" approach:
 - ✓ IRS will not assert that there has been a taxable termination, as long as the economic benefit continues to be recognized.
 - ✓ The taxation of the participant's equity at the time of termination of the SDA ("roll-out") is not specifically addressed, but the implication is that it is taxable at that time.
 - "No inference" language.



Section 409A

- Final Regulations and Notice 2007-34 issued April 2007.
- Exceptions to Section 409A:
 - SDAs providing only death benefits and death benefit only plans,
 - SDAs structured as loan arrangements (unless waived, cancelled or forgiven).
- SDAs subject to Section 409A:
 - Any compensatory SDA that includes an element of deferred compensation that is not grandfathered.
 - ✓ If the participant's equity in a pre-September 18, 2003 SDA is taxable at roll-out (as implied by Notice 2002-8), it would represent deferred compensation subject to Section 409A.



Arrangements Grandfathered Under Section 409A

- In general, any right to deferred compensation earned and vested prior to January 1, 2005.
- With respect to an SDA:
 - Premiums paid prior to January 1, 2005, and related earnings.
 - Premiums paid after January 1, 2005, and related earnings, if the right to such premium payments was earned and vested prior to that date.



Loss of “No Inference” Protection

- “No inference” language included in Notice 2002-8, but not in Notice 2007-34.
- No such protection, therefore, may be available with respect to a SDA subject to Section 409A.



Section 409A Requirements

- Deferred compensation must be payable at set times or events,
- Payment cannot be in the discretion, directly or indirectly, of the employee/participant.



Consequences of Violating Section 409A

- All deferred compensation for the present year and all preceding years is includable in taxable income of the employee/participant,
- Tax on compensation increased 20% and,
- Interest charged on income in preceding years at underpayment rate plus 1%.



Modifications to Agreement to Comply With Section 409A

- Notice 2007-34 indicates that a modification is not a “material modification” under the split-dollar regulations if:
 - The Employer had reasonably determined:
 - ✓ That Section 409A applies,
 - ✓ The SDA is not in compliance and,
 - ✓ The modifications bring the SDA into compliance, or result in Section 409A not applying.
 - The modifications consist only of changes to:
 - ✓ Applicable definitions,
 - ✓ Payment timing requirements and/or,
 - ✓ Changes to conditions of forfeiture.
 - The modifications are consistent with the terms of the original agreement and,
 - The beneficiary’s rights under the agreement are not materially enhanced.



Modifications to Agreement to Comply With Section 409A (Cont.)

- Amendments to consider for Section 409A compliance:
 - Restriction of the timing of the roll-out to a specified date or permissible event,
 - Delay of access to cash value for Key Employees for 6 months beyond roll-out date,
 - Elimination of any provision that allows a participant to terminate the SDA his/her discretion and,
 - Elimination of automatic termination provisions (such as for non-payment of the participant's premium contributions).



Other Planning Alternatives

- Conversion of the SDA to a “Bonus” plan structure or,
- Conversion of the SDA to an “Executive Roth Plansm.”



EITF 06-4, “Accounting for Endorsement Split-Dollar Arrangements”

- Effective for fiscal years beginning after December 15, 2007.
- EITF rationale for consideration of this issue:
 - Diversity of current accounting practice and,
 - Concerns expressed by auditors regarding non-recognition of liability.
- EITF findings:
 - FASB Statement 106 applies if there is a post-retirement benefit.
 - The purchase of a life insurance does not “settle” the Employer’s obligation.
 - The method of accrual of the liability depends upon the substance of the Employer’s promise:
 - ✓ To maintain a policy on the life of the employee or,
 - ✓ To pay a death benefit.
 - No related deferred tax benefit.



EITF 06-4 (Cont.)

➤ Historical accounting treatment:

- Employer recognized no liability for the post-retirement death benefit as the obligation was considered “settled” through the purchase of the life insurance.
- Employer recorded a cash value asset equal to 100% of the policy cash value (or its share of the death benefit, if less).



EITF 06-4 (Cont.)

- New accounting requirements – Employer must recognize a liability based on the nature of the promise:
 - If promise is to maintain the policy in-force:
 - ✓ The present value of the projected post-retirement cost of insurance is accrued over the service period of the participant.
 - ✓ The liability is reversed as the cost of insurance is incurred in the post-retirement years.
 - ✓ At death, any remaining liability is reversed into income.



EITF 06-4 (Cont.)

➤ New accounting requirements (Cont.):

- If promise is to pay a post-retirement death benefit (whether or not a policy is in-force):
 - ✓ The present value of the death benefit at expected mortality is accrued over the service period of the participant.
 - ✓ After retirement, the present value of the liability continues to grow with interest until it equals the nominal death benefit at normal mortality.
 - ✓ At death, if the policy is still in-force, the liability is reversed.



EITF 06-4 (Cont.)

- Accounting for transition – Treated as a change in accounting principle recorded through either:
 - A “cumulative effect” adjustment or,
 - Retrospective application to all prior periods.



EITF 06-4 (Cont.)

➤ Planning alternatives:

- Elimination of the post-retirement death benefit under the plan.
- Conversion of the plan to a Death Benefit Only (DBO) structure:
 - ✓ Advantage – Recognition of deferred tax benefit
 - ✓ Disadvantage – Loss of use of ILIT



EITF 06-10, “Accounting for CASD Arrangements”

- Effective for fiscal years beginning after December 15, 2007
- EITF rationale for change – Historical accounting inconsistent and, in some cases, inappropriate.
- EITF 06-10 addresses two issues:
 - Whether or not a post-retirement benefit obligation should be recorded and,
 - The measurement of the asset.
- EITF 06-10 does not apply to an arrangement that:
 - Has no compensatory element or,
 - Provides no post-retirement benefits (death benefit or cash value accumulation).



EITF 06-10 (Cont.)

- Findings – The accounting treatment should reflect the substance of the Employer’s promise - either a post-retirement benefit obligation or a below market loan?
 - If a post-retirement benefit obligation, is the nature of the Employer’s promise:
 - ✓ To maintain an insurance policy in-force during retirement or,
 - ✓ To provide a post-retirement death benefit?
 - If a below market loan, is it:
 - ✓ A term loan,
 - ✓ A demand loan and,
 - ✓ Is it impaired?



EITF 06-10 (Cont.)

➤ Historical accounting treatment:

- Employer recognized no liability and,
- Recorded an asset equal to the lesser of 100% of cash value or cumulative premiums paid.



EITF 06-10 (Cont.)

- New accounting requirements vary based on substance of arrangement – post-retirement benefit obligation or below market loan:
 - Benefit obligation:
 - ✓ If Employer’s promise is to maintain a policy in-force, the estimated cost of insurance in retirement must be recorded as a liability under either FAS 106 or APB 12.
 - ✓ If Employer’s promise is to provide a specific post-retirement death benefit, the actuarial present value of the death benefit must be accrued under either FAS 106 or APB 12.
 - ✓ The cash value asset should be recorded at 100% of policy cash value.



EITF 06-10 (Cont.)

➤ New Accounting requirements (Cont.):

▪ Below market loan:

- ✓ No liability is recognized for a benefit obligation.
- ✓ The amount of cash value recognized depends on whether it is a term or demand loan.
 - If term loan, premium repayment discounted at the market rate. Compensation equal to the discount is imputed to the participant in year 1.
 - If a demand loan, compensation is imputed to the participant, and interest income is imputed to the Employer each year at the excess of the market rate over the stated rate.
 - If the loan is impaired (i.e., the cash value of the policy is less than premiums advanced), the recorded value of the asset is limited to the cash value.



EITF 06-10 (Cont.)

- Benefit obligations vs. below market loans – not always clear.
 - Does the arrangement provide for a specific post-retirement death benefit?
 - Does the arrangement target an amount of cash value accumulation at retirement?
 - Has the Employer promised to continue premium payments into retirement?
 - Who bears the risks and rewards of policy performance?
 - Is there an agreement to forgive repayment of some or all of the premiums advanced?
 - How is the arrangement treated for Sarbanes-Oxley – as a loan?
 - Can the Employer cancel the arrangement and demand repayment at any time?



EITF 06-10 (Cont.)

- Accounting for transition – Treated as a change in accounting principle recorded through either:
 - A “cumulative effect” adjustment or,
 - Retrospective application to all prior periods.



Summary

- Recent tax and accounting developments regarding SDAs require immediate consideration:
 - Section 409A creates potential exposure for participants to back taxes, penalties and interest with respect to pre-September 18, 2003 arrangements and,
 - The EITF accounting changes may have an immediate impact on shareholders' equity and an on-going impact on the P&L.
- Certain planning alternatives are available to limit the impact of these regulatory changes in a manner that maintains the value of benefits to participants on a cost effective basis to the sponsor.



Contact Information

www.retirementcapital.com

Retirement Capital Group, Inc.

12340 El Camino Real, Suite 400
San Diego, CA 92130

Phone: (866) 724-4877

Fax: (858) 677-5915

E-mail: info@retirementcapital.com

Website: <http://www.retirementcapital.com>

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Chris Rich, Registered Representative

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