Accounting Treatment for Mutual Funds vs. COLI

This memo summarizes our understanding regarding the accounting treatment of a company's interest in Corporate Owned Life Insurance (COLI) and that used with other investments such as mutual funds. This information is provided for discussion purposes only and should be reviewed by appropriate tax and accounting professionals.

Mutual Funds

If a company acquires mutual funds, any realized investment earnings are taxable to the company. FASB Statement 115 (FAS 115) addresses the accounting for investments in equity securities that have readily determinable fair values, and for all investments in debt securities. The investments covered are to be classified in three categories and accounted for as follows:

1) **Held-to-Maturity:** Debt securities that the company has the positive intent and ability to hold until maturity are reported at amortized **cost.** Under FAS 115, this method is generally considered inappropriate to use for mutual funds financing a deferred compensation plan liability.
2) **Trading:** Debt and equity securities that are bought and held principally for the purpose of selling them in the near future are reported at **fair value,** with **unrealized gains and losses** *included* **in earnings.** For practical purposes gains are shown **net of taxes** due to the need to establish a deferred tax expense under FAS 109.
3) **Available-for-Sale:** Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale and reported at **fair value,** with **unrealized gains and losses** *excluded* **from earnings** and reported in a separate component of shareholder's equity. For practical purposes gains are shown **net of taxes** due to the need to establish a deferred tax expense under FAS 109.

Type of Income Considerations: Generally corporations include net capital gains in gross income and such gains are taxed at the corporation's regular tax rate. Corporations do receive a deduction for 70% of dividends received from other domestic corporations. This deduction may increase if the corporation owns a 20% or more interest in a company.

Corporate Owned Life Insurance (COLI)

Accounting for COLI is governed by FASB Technical Bulletin 85-4 and differs significantly from the treatment afforded mutual funds. With COLI, the **cash value increases are included in earnings.** If the policies are intended to be held to death, the assumptions realized, and current tax treatment continues, the cash value in excess of premium tax basis may never be taxed under IRC §101. Therefore, there is **no deferred tax expense** under FAS 109.

Comparison of Accounting Treatment

	Held to Maturity Securities*	Trading Securities	Available for Sale Securities	Life Insurance
FASB Rules	Stmt. #115	Stmt. #115	Stmt. #115	FASB Technical Bulletin 85-4
Definition	Debt securities (e.g., bonds) where the holder has the positive intent and ability to hold securities to maturity	Securities bought & held principally for purpose of active trading in the short term for profit	Investments not classified as either Held to Maturity or Trading	Life insurance policies owned by the entity
Balance Sheet Treatment	Carried at amortized cost (i.e., no mark-to-market)	Mark-to-market - included at FMV – net of taxes	Mark-to-market - included at FMV – net of taxes	Cash surrender value
P&L Inclusion	Realized gains (interest) plus amortization of acquisition discount or premium	Realized gains/losses (dividends, sales) and unrealized holding gains & losses included in current earnings	Only realized gains/losses included in current earnings. Unrealized holding gains & losses booked to a special shareholder equity account	Increase in annual cash surrender value over premium paid booked as expense or income

* This method is generally considered inappropriate to use for mutual funds financing a nonqualified plan liability.

EXAMPLE

Corporation A maintains several nonqualified retirement plans. Currently, the balances of the plans are $10 million in aggregate. The plan liabilities grow 8% in 2006 (to $10.8 million). A 35% tax rate is assumed.

Mutual Funds Financing: The plan may be informally financed with tax managed mutual funds designed to generate a similar return. These would likely be accounted for as "available for sale." As such, the funds would see approximately an $800,000 increase in value. Assuming these returns are all unrealized, a $520,000 ($800,000 less $280,000 of deferred taxes1) increase in shareholder equity would result.

COLI Financing: The plan may be informally financed with corporate owned life insurance designed to generate a similar return. As such, separate accounts in the policy would see approximately an $800,000 increase in value before insurance policy related costs are deducted. In an average year, these costs would reduce the account value by approximately 100bps. The $700,000 cash value increase would be included in earnings.

Result: The financial statement benefit from using COLI under this scenario would be approximately $180,000. Additionally, the earnings would flow through the P&L, helping to offset costs from the underlying nonqualified retirement plan accruals.

a Reflected as earnings flow through to P&L
b Reflected as direct increase in shareholder equity

	Mutual Funds	COLI
Balance Sheet BOY	**10,000,000**	**10,000,000**
Realized Gains[a]	0	-
Unrealized Gains[b]	800,000	-
Cash Value Increase[a]	-	700,000
EOY Deferred Tax Liability	700,000	-
Balance Sheet EOY	**10,520,000**	**10,700,000**

[1]Does not take into account the amount of dividends that may be excluded.

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