Interpretation of the Emerging Accounting Issues Working Group

INT 01-17: Accounting for Nonqualified Retirement Plans, Nonvested Ancillary Benefits Within Retirement Plans, and Protected Benefits Such as Early Retirement Subsidies in Retirement Plans

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INT 01-17 Dates Discussed

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INT 01-17 References

SSAP No. 8—Pensions (SSAP No. 8)

INT 01-17 Issue

1. Calculations of the Projected Benefit Obligation (PBO) and Service Cost (SC) under SSAP No. 8 are identical to calculations under the FASB Statement No. 87, *Employers' Accounting for Pensions* (FAS 87), except for the treatment of nonvested benefits. Under FAS 87, a participant's status as pre- or post-vested in benefits receives no differential treatment. SSAP No. 8 contains clauses that indicate nonvested benefits are to be ignored until the employee becomes eligible and vested.

2. A defined benefit plan covered by ERISA is a type of deferred compensation arrangement. A plan's primary purpose must be to provide replacement income to a participant following retirement. The benefits that are to be received may or may not become vested (although this term is often used, the legal term is "nonforfeitable") prior to actual retirement. A plan is only required to provide nonforfeitability provisions if the plan seeks qualification under the Internal Revenue Code. On the other hand, in order to remain nonqualified, the plan may only cover a select group of highly compensated employees. In substance, nonqualified plans are identical to deferred compensation plans, where the only difference may be that a nonqualified plan is provided solely at the discretion of the employer and whether or not to participate in a deferred compensation plan may be predicated on a decision of the employee. Both qualified and nonqualified plans are nearly universal throughout the insurance industry.

3. A more narrowly defined term in qualified plans is "protected" benefits under Internal Revenue Code Section 411(d)(6). These are the benefits that the employer cannot take away through amendment (including termination) of the plan. Examples of protected benefits are alternative forms of payment, retirement-type subsidies (e.g., early retirement benefits) and qualified pre-retirement joint and survivor benefits (this is the only ancillary benefit that is protected). Protected benefits need not be nonforfeitable. For example, an early retirement subsidy applicable to a currently accrued benefit cannot be taken away through an amendment to the plan. However, the participant may lose their right to collect the subsidy if they terminate prior to becoming eligible to receive it.

4. Example: Assume a plan has a subsidized early retirement benefit (defined benefit plans almost universally do) that is only payable if retirement occurs directly from active employment. The PBO under FAS 87 for a participant is $200,000, where $50,000 of this is due to the subsidized early retirement benefit. i.e., if we assume the person retires at normal retirement, the PBO would only be $150,000. It is not clear whether the PBO should be $150,000 or $200,000 under SSAP No. 8. The $50,000 is not a nonforfeitable benefit, i.e., if the person terminates prior

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to becoming eligible for the early retirement benefit, they only receive a benefit worth $150,000. However, the $50,000 is a protected benefit that cannot be taken away through a plan amendment. As long as the participant remains in active employment and eventually become eligible, they will have a right to receive this benefit. For a second example, assume the subsidized early retirement benefit in the prior example is available no matter when the participant terminated employment. (The common 1/15th, 1/30th reduction used in integrated plans is a subsidized early retirement benefit that is typically available to previously terminated participants.) In this case, the early retirement subsidy is nonforfeitable and the entire $200,000 would be the PBO under SSAP No. 8.

5. In addition to replacement income at retirement, retirement plans contain a variety of ancillary benefits, most of which are not nonforfeitable. For example, all death and disability benefits except for the qualified pre-retirement joint and survivor benefit might only become nonforfeitable once the triggering event (death or disability) occurs. Some plans do provide nonforfeitability provisions to these ancillary benefits, but that is rare. The easiest test as to whether an ancillary benefit is nonforfeitable is whether or not the participant still receives that benefit when the triggering event happens after termination of employment. The qualified pre-retirement joint and survivor death benefit is one such benefit that is still available after termination of employment. Nearly all defined benefit plans contain ancillary benefits that do not become nonforfeitable.

6. Nonqualified plans typically do not have nonforfeitability provisions connected with any benefit, including the main retirement benefit. The reason for this is the application of the constructive receipt standard under the Internal Revenue Code. Under this standard, there must be a “substantial risk of forfeiture” in order to avoid constructive receipt. At the point when the benefits lose this substantial risk of forfeiture, i.e., become nonforfeitable, the value of the benefits becomes taxable income to the participant even though no benefits have been paid. Therefore, most nonqualified plans do not contain provisions for nonforfeitability, i.e., the benefits never vest prior to payment. Typically, the only situation where there is nonforfeitability is when a “secular trust” is used to fund the benefits. These trusts are owned by the participant and income taxes must be paid on employer’s contributions to the trust and the earnings thereon. A similar type of trust which is used more often to fund nonqualified benefits is a “rabbi trust.” These do not invoke such taxation because they are available to creditors (and policyholders) in the event of bankruptcy (or insolvency), which is a sufficient condition to invoke a “substantial risk of forfeiture.”

7. Another aspect of nonforfeitability that is often overlooked is that it only applies to living participants. If a participant dies, they may not have any benefits due to them. For example, assume a plan does not contain any ancillary death benefits other than the required qualified pre-retirement joint and survivor benefit. If a single participant dies prior to retirement, the estate will receive nothing from the plan. In accounting terms, assume the PBO associated with this person is $500,000. This represents the present value of the projected retirement benefit accrued to date. Within that present value calculation are assumptions discounting the value for the probability of not receiving anything upon death. If the participant dies, the PBO reverts to zero and there is a $500,000 unrecognized gain that is amortized. Even though the participant was 100% vested in a retirement benefit worth $500,000, there is no guarantee that the plan is responsible to pay it, unless the participant lives to receive it.

8. As a separate example, assume the same facts except that the plan contains an ancillary death benefit equal to the present value of the retirement benefit, not discounted for pre-retirement mortality. Assume the amount paid out upon death is $600,000 and the PBO associated with the value of this death benefit is $100,000. The aggregate PBO under FAS 87 would be $600,000. Whether the participant lives until retirement or dies prior to retirement, a benefit will

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be paid out in the future that is worth $600,000 today as long as the participant remains employed. Under SSAP No. 8, only $500,000 would be valued in the PBO because the death benefit is not a nonforfeitable benefit.

9. For married participants, the same loss of benefits can occur upon death, except that there is a minimum death benefit equal to the qualified pre-retirement joint and survivor annuity. This death benefit may only be worth 40-45% of the retirement benefit. So, in the case of a plan that contains a death benefit described in the second example above, part of the extra $100,000 (e.g., 45% of it) is a nonforfeitable benefit for married participants, whereas the remaining part is not nonforfeitable, similar to the single participant's situation.

10. Summarizing, there are many aspects of vesting beyond a vesting schedule applied to the normal retirement benefit. Also, most nonqualified plans never have any vesting applied. In addition, there are benefits associated with retirement benefits that are protected, but not vested (i.e., if the participant stays in employment until eligible, they have the right to receive them, but if they terminate sooner, they may lose those rights).

11. Returning to SSAP No. 8, the following are the references to vesting:

> Paragraph 2: "...with a modification to exclude nonvested employees. Therefore, the cost related to services rendered prior to becoming eligible and vested in the plan..."

12. This could be referring to both nonvested retirement benefits and to ancillary benefits. However, the confusion here is the use of the term "nonvested employees" rather than "nonvested benefits". An employee can be vested in one benefit while not vested in another. The protected benefits that are not nonforfeitable (e.g., subsidized early retirement benefits) may also be included in this statement because of the reference to "becoming eligible".

> Paragraph 15(a): "Calculation of the pension obligation shall exclude non-vested employees. Partially vested employees are included only to the extent of their vested amounts;"

13. Again, the confusing aspect of this is the reference to employees, rather than benefits. In this case, the statement "...extent of their vested amounts;" could mean that ancillary benefits are amounts that would not be included. After all, every participant is a "partially vested employee" when all benefits are considered.

14. The accounting issue is when applying SSAP No. 8 to calculations for the accounting of defined benefit plans:

Issue 1 - Should nonvested, ancillary benefits (primarily death and disability benefits) be ignored in the PBO and SC prior to the triggering event (e.g., death or disability) of these benefits?

Issue 2 - Should protected, nonvested benefits (e.g., retirement-type subsidies such as early retirement benefits) be ignored in the PBO and SC prior to becoming eligible for these benefits?

Issue 3 - Should nonvested, nonqualified benefits be ignored prior to retirement or when there is no longer a substantial risk of forfeiture?

INT 01-17 Discussion

15. The working group reached the following consensus's on the three issues raised:

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Issue 1 - Should nonvested, ancillary benefits (primarily death and disability benefits) be ignored in the PBO and SC prior to the triggering event (e.g., death or disability) of these benefits?

The working group reached a consensus that nonvested, ancillary benefits should not be ignored in the PBO and SC prior to the triggering event of these benefits. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

Issue 2 - Should protected, nonvested benefits (e.g., retirement-type subsidies such as early retirement benefits) be ignored in the PBO and SC prior to becoming eligible for these benefits?

The working group reached a consensus that protected, nonvested benefits should not be ignored in the PBO and SC prior to the employee becoming eligible for these benefits. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

Issue 3 - Should nonvested, nonqualified benefits be ignored prior to retirement or when there is no longer a substantial risk of forfeiture?

The working group reached a consensus that nonvested, nonqualified benefits should not be ignored in the PBO and SC prior to retirement or when there is no longer a substantial risk of forfeiture. A liability for these benefits should be accrued in accordance with the guidance in FAS 87 (use of a general vesting standard rather than an Internal Revenue Service income tax vesting standard).

INT 01-17 Status

16. No further discussion planned.

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