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 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

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 situ21.s4 -1.1 35 Tw git. T3have T3hai25d[l2-di463 TwTc 0

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:

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".

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

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?