Accounting guidelines for nonqualified defined benefit plan

As it relates to a for-profit company, the accounting for the nonqualified defined benefit plan is generally made up of two separate categories of entries:

1) **First set of entries.** To account for the deferred compensation benefit as a deferred compensation expense and to record the benefit as a liability.
2) **Second set of entries.** To account for the informal financing of the defined benefit plan liability using corporate-owned taxable investments or variable corporate-owned life insurance (COLI).

Following is a general discussion of the applicable accounting principles. Please keep in mind that the company should determine, in consultation with its accountants and auditors, the accounting treatment that will be used for financial reporting.

GAAP guidelines

The Financial Accounting Standards Board (FASB) is responsible for establishing non-governmental U.S. Generally Accepted Accounting Principles (GAAP). Effective for accounting periods ending after September 15, 2009, the FASB Accounting Standards Codification (ASC Codification) is the single source of authoritative U.S. GAAP. For convenience, these accounting guidelines include both pre- and post-codification references to GAAP.

Expense and liability

ASC 715-30 (SFAS 87 and SFAS 158) entitled “Defined Benefit Plans – Pension” is used for measuring cost (expense) and reporting liabilities resulting from defined benefit pension plans, including nonqualified plans.

Corporate-owned taxable investments

If taxable investments are used to informally finance the plan, the company follows **ASC 825-10-25 (SFAS 159)** entitled “Financial Instruments” to account for these assets. Under **ASC 825-10-25** all realized and unrealized earnings are recognized currently on the income statement. See “Fair Value Measurement” at **SFAS 157** for additional disclosure requirements. The sample guidelines contained here assume the use of the fair value method.

Life insurance

If corporate-owned life insurance is used to informally finance the plan, **ASC 325-30-35 (TB 85-4 and EITF 06-5)** entitled “Investments in Insurance Contracts” should be your reference.

Income taxes

The defined benefit plan liability creates an expense that's deductible for tax purposes only when it's paid to the plan participant. These expenses would be grouped with all other deductible temporary differences to compute the deferred tax asset. This deferred tax asset is accounted for under Income Taxes **ASC 740-10-25 (SFAS 109)**. A deferred tax **liability** is recognized for temporary differences that result in taxable amounts in future years, such as unrealized gains on corporate-owned taxable assets. These deferred tax accounts are based on **ASC 740-10-25** guidance.

Expense and liability (ASC 715-30 & 740-10-25 / SFAS 87, 158 & 109)

Expense and liability entries	Balance sheet		Income statement	
	Debit (DR)	Credit (CR)	Debit (DR)	Credit (CR)
1. Establish prior service cost				
Accumulate other comprehensive income	$200,000			
Benefit liability		$200,000		
2. Accounting for the current year				
For benefit accrual:				
Net periodic benefit cost			$100,000	
Benefit liability		$100,000		
For amortization of prior service cost or amortization of past years' gains/losses:				
Net periodic benefit cost			$10,000	
Accumulate. other comprehensive income		$10,000		
For plan losses in the current year (or reverse entry if plan gains):				
Accumulate. Other comprehensive income	$50,000			
Benefit liability		$50,000		
3. Periodic distribution of benefits to plan participants				
Benefit liability	$50,000			
Cash		$50,000		

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Expense and liability (ASC 715-30 & 740-10-25 / SFAS 87, 158 & 109) - **Continued**

Expense and liability entries	Balance sheet DR	Balance sheet CR	Income statement DR	Income statement CR
Tax effects				
1. Nondeductible defined benefit liability				
Deferred income tax asset	$50,000			
Income tax expense				$50,000
2. Nondeductible defined benefit deferred compensation expense				
For benefit accrual:				
Deferred income tax asset	$25,000			
Tax expense				$25,000
For amortization of prior service cost:				
No tax effect				
For plan losses in the current year (or reverse entry if gain):				
Deferred income tax asset	$12,500			
Tax expense				$12,500
3. Deductible distribution of benefits to plan participants				
Cash	$12,500			
Deferred income tax asset		$12,500		

Nonqualified distributions are only deductible when paid

(1) The company books the prior service cost as the benefit liability and also sets up an account for accumulated other comprehensive income. The deferred compensation benefit is not currently deductible for taxes, and the company accrues the future tax benefit as a deferred tax asset ($200,000 x 25%).

(2) As benefits accrue, the net periodic benefit cost is an expense that includes (a) the participants' service cost and interest cost, and (b) the amortization of any prior service cost and amortization of applicable past gains/losses. As the amortization occurs, that amount is reversed out of accumulated other comprehensive income. Gains/losses in the current year are accounted both in the benefit liability and in accumulated other comprehensive income. As the benefit liability increases ($100,000 for benefit accrual plus $50,000 for plan losses, in this example), the company accrues an additional future tax benefit ($150,000 x 25%)

(3) Paying the plan participant with cash. The payment is currently deductible for taxes, which reverses the deferred income tax asset ($50,000 x 25%).

Accounting for gains on corporate-owned taxable investments

(Financial instruments ASC 825-10-25 / SFAS 159)

Corporate-owned taxable investment entries	Balance sheet DR	Balance sheet CR	Income statement DR	Income statement CR
1. Purchase of mutual fund(s) to informally finance defined benefit liability				
Mutual fund(s)	$100,000			
Cash		$100,000		
2. Mutual fund(s) realized earnings				
Mutual fund(s)	$5,000			
Other income				$5,000
3. Mutual fund(s) unrealized earnings				
Mutual fund(s)	$3,000			
Other income				$3,000
4. Sell mutual fund(s) and close account				
Cash	$108,000			
Mutual fund(s)		$108,000		
Tax effects				
1. No tax effect				
2. Tax paid on realized earnings				
Income tax expense			$1,250	
Cash		$1,250		
3. Tax effect of unrealized earnings				
Income tax expense			$750	
Deferred income tax liability		$750		
4. Tax paid on realized earnings				
Deferred income tax liability	$750			
Cash		$750		

Under ASC 825-10-25, both realized and unrealized earnings are recognized in the income statement

Realized earnings create current income tax

Unrealized earnings create a future tax liability

(1) The company pays $100,000 to open a mutual fund account. There is no tax effect.

(2) The mutual fund(s) increases $8,000 of which 25% ($2,000) was realized interest, dividend and capital gains distributions and of which 50% of the undistributed gains ($3,000) was realized capital gains due to rebalancing. Realized gains are currently taxable to the company resulting in additional tax of $1,250 paid ($5,000 x 25%).

(3) The mutual fund(s) increases $8,000 of which $3,000 was unrealized gain (increase in NAV). Unrealized gains are credited to current earnings. Unrealized gains create a deferred income tax liability, due to $750 in tax being owed at a future time ($3,000 x 25%).

(4) The company sells the mutual fund(s), deposits proceeds into cash. At this point, the company pays $750 in tax on the **realized** gains upon sale ($3,000 x 25%).

Accounting for investments in life insurance

(Investments in insurance contracts ASC 325-30-35 / TB 85-4 & EITF 06-5)

Life insurance entries (based on Executive Variable Universal Life insurance)	Balance sheet DR	Balance sheet CR	Income statement DR	Income statement CR
1. Company pays premium into insurance contract				
COLI asset (CSV)	$100,000			
Cash		$100,000		
2. Adjustment to cash surrender value (CSV) in the insurance contract				
Premium expense			$3,000	
COLI asset (CSV)		$3,000		
3. Partial withdrawal of CSV (surrender or loan) and deposit into cash				
Cash	$10,000			
COLI asset (CSV)		$10,000		
4. Plan participant dies at end of year one with $1,000,000 of death benefit				
Cash	$1,000,000			
Non-taxable life insurance proceeds				$913,000
COLI asset (CSV)		$87,000		

Tax effects

1. **No tax effect.** Life insurance premiums are not tax deductible.
2. **No tax effect.**
3. **No tax effect.** Loaned amounts or a return of cost basis from a life insurance policy is non-taxable.
4. **No tax effect.** Proceeds from death benefits are non-taxable.

No tax effects when using corporate-owned life insurance

(1) The company contributes cash into a corporate-owned life insurance policy to accumulate funds to finance future benefit payments.

(2) The cash surrender value (CSV) is accounted for as an asset and offsets the life insurance premium expense.

(3) The company can withdraw money from the CSV in the form of a surrender or loan and deposit into company cash to pay a deferred compensation benefit to a plan participant.

(4) When the plan participant dies, the company receives the death benefit proceeds and recognizes the non-taxable income (the difference between the death benefit and the CSV).

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