Workshop 10:
Significantly Overfunded and Underfunded DB Plans

Presented by:
Steven J. Levine, MSPA
Thomas J. Finnegan, FSPA
Use of Pension Surplus

• Awareness of funding issues

• Very relevant related to economy

• Media coverage
  ✓ Washington Post / NYT / WSJ

Strategic Use of Pension Surplus

• Effective management techniques

• Merger/acquisition transactions
What actually is “surplus”?

• No unique definition
  • Financial reporting purposes
  • Realizable value
  • Funding

• Based on actuarial assumptions

“Surplus” defined?

Most common measurement standards

➢ Financial Accounting Standards (FASB)
➢ ERISA / IRC funding standards
➢ PBGC termination basis
➢ Other?
FASB Basis

• For company financial statements
• Market related asset value
• Liabilities: ABO vs. PBO
• Discount rate determined
• Settlement & Curtailment

Accounting treatment matters

• Plan termination involves a settlement
• Annuity purchases will generate a settlement loss
• Penalty taxes are losses
• Termination triggers full recognition
• Net result is often a loss
ERISA & IRC Standards

- ERISA & IRC minimum funding standard
- Actuarial value of assets
- Target Liability
- Actuarial accrued liability

PBGC Plan Termination Basis or Lump Sum

- ERISA §4044 categories
- PBGC safe harbor
- Assets at market value
- Lump sums using 417(e) rates
Available options

Reduced plan liabilities

- Increase in interest rate
- Favorable actuarial experience
- Reduction in future benefits
- Business sale or workforce reduction

Available options

Recapture Restrictions

- Surplus can arise under many different scenarios
- After satisfaction of all liabilities
- Can revert due to “actuarial error”
Recapture – Actuarial Error

• After satisfaction of all liabilities
• Annuity contracts, lump sums
• Anti-cutback rules

Recapture – Actuarial Error

• Spin-off terminations
• Plan must provide for it
• 5 year amendment rule
Joint Guidelines on Reversions

DOL  IRS  PBGC

- Effective in 1984
- Purchase of annuities
- 15-year moratorium
- Full vesting
- No allocation of surplus in terminating plan

Reversion Penalty taxes

IRC §4980

- Relates to reversions from terminated plans
- Non deductible excise tax of 50%
- Total taxes up to 100% considering all state & local
Reversion Penalty taxes

**IRC §4980 - Reduced tax of 20%**

- Establishment of replacement plan
- Increase benefits to eligible participants
- Allocate over 7 years
- **RR 2003-85** - QRP can be 100% of surplus no tax

Some IRS guidance on IRC § 4980

- **PLR 9318035** - Merger of OF salaried plan with UF hourly plan
- **PLR 199935076** – no § 4980 tax to absorb MPP ees
Some more IRS guidance

- PLR 200150028
  - No § 4980 tax on merger
- PLR 200216034
  - Municipalities merging overfunded and underfunded plans
- CONCLUSION - It appears that a transfer of liabilities without assets from an underfunded plan to overfunded plan within Controlled Group is not a reversion

Exclusive Benefit Rule Guidance

- TAM 9516005 – SERP benefit liability assumed by a OVERFUNDED DB plan DID NOT VIOLATE the exclusive benefit rule
- RR 2008-85 – Moving an UNDERFUNDED DB Plan out of a controlled group DID VIOLATE the exclusive benefit rule
Indirect reversions

• **PLR 9136017** – One of very few rulings we could find that invoked indirect reversion

• In merger situation Service is not likely to raise issue

*GCM 39744*

“As under current law, there will be no income or excise tax consequences if excess assets are transferred or merged between defined benefit plans maintained by an employer or employers within the same controlled group....”
Exceptions to IRC § 4980 tax

- Governmental plans
- At all times tax exempt
- Mistake in fact/law
- Failed to initially qualify
- ESOP exemption
- Liquidating Ch 7 bankruptcy

Surplus to improve funded status

- Merge overfunded with underfunded
- Cannot reduce benefits ERISA §208 IRC §§401(a)(12), 414(l)
- Reduced PBGC variable rate premiums
Historical Litigation

• Employee challenges
• Litigation challenging spin-offs
• Courts have generally sided with employers

Hughes Aircraft Case

• Defends Employers right to surplus
• Contributory plan
• Used surplus to benefit current employees
• Employees sued for portion of excess
Surplus Options

- Improve benefits
- COLA to retirees
- Social Security supplement

Surplus Options

- Benefits that serve corporate objectives
- Grandfathering
- Retirement windows
Surplus Options

Supreme court cases

✓ Hughes Aircraft v. Jacobson
✓ Lockheed Corp. v. Spink
✓ New Coleman Holdings

All cases stand for the Employer’s right to any surplus

Other Surplus Options

Separation / Severance benefits

– GCM 39869 – shutdown benefits
– Voluntary / Involuntary terminations
Other Surplus Options

Qualified Supp. Ret. Benefits (QSRP)

– Improved cash flow / benefit security
– Without reference to compensation
– Mirror plans

Parachute Payments

• Shift payments to overfunded plan
• Not subject to “golden parachute” rules
• Non discrimination rules
• Just enough to fall below thresholds
Disability Benefits

- Disability benefit cannot exceed projected normal retirement benefit
- Can be in addition or replacement for LTD
- Must keep benefits ancillary
- Taxation may differ from insured LTD

Death Benefits

- Non discriminatory & “Incidental”
- Non Insured Benefits – MAX PVAB
  – No employee tax
  – Beneficiary taxed on payment
- Insured benefits
  – 100 x projected pension
  – PS-58 costs (IRS Notice 2001-10)
Buy Company Stock

- Invest up to 10% in Qualifying Employer Securities
- Notes & bonds as well as stock
- Prohibited Transactions Exemption
- Subject to fiduciary duty requirements

Retiree Medical Benefits

Surplus transferred to §401(h) account to fund retiree medical (IRC §420) requires:

✓ Separate Accounting

✓ Full vesting
Retiree Medical Benefits

Additional IRC § 401(h) / IRC § 420 requirements:
- Only one year cost
- 125% cushion
- Exempt from § 4980 & § 4975 (PT)
- Detailed requirements – care needed
- Expires 12/31/2021

Pay administrative expenses

- Must be reasonable
- Services on behalf of the plan
- Cannot absorb much surplus
Pay administrative expenses

“Slippery Slope”

• Cannot pay settlor expenses

• Recent DOL guidance

Employer Profit Sharing

• Add supplemental cash balance feature to replace current PSP contribution
• §401(k) matching contributions not eligible
• Contingent benefit rule
• May work with matching contributions to §403(b)
More on Life Insurance

• Non Title I Plans – “sponge policies”
• Exceeds Incidental benefit limits
• DOL PTE 92-6 – allows policy to be sold to participant
• Transfer for value rules require participant participate in the purchase

General concerns

• Possible “indirect” reversions
• Use of plan assets to benefit Employer

TAM 9516005 – Qualified DB plan assumed corporate SERP liability – no PT or exclusive benefit violation
Sale / Purchase of Business

• When asset & liability transfers are part of price excess & “indirect” reversion?

• TAM 9650002
  – Released in 1999
  – IRC §338 – deemed asset sale
  – Prior to §4980 (prior to 1/1/86)
  – Required ordinary income vs. capital gain treatment

IRC §4980 distinction

• Plan MUST be terminated to get there

• Requires Employer to receive payment from the plan
IRC §4980 distinction (con’t)

• When buyer uses own assets, definition of reversion is not met

• Especially if no funds are removed from the plan and the plan remains in tact

• Routinely used in buy/sell situations and IRS never raised issue

Can surplus be “sold”? 

• Valuable to underfunded plan sponsor
• Can transfer agreed upon surplus
• Must comply with IRC §414(l)(2)
Can surplus be “bought”?

- Purchase price will reflect value
- Economic benefit without terminating
- Explicit reference can risk examination
- See *In re Gulf*, 13 EBC (1992)

Transactions - Traditional

- Shareholders sell company, division or subsidiary. Plan has surplus

- Buyer has underfunded plan and funding requirement & tax reason
Transactions - Traditional

- Seller - cash needs and substantial surplus
- All terms negotiated – all assets / liabilities

Transaction – Non Traditional

NOT PERMITTED per RR 2008-85

- Seller is underfunded looking to discount PBGC/Annuity obligation
- Buyer typically has overfunded plan
Transaction – Non Traditional

NOT PERMITTED RR 2008-85

- Seller provides additional capital
- Buyer merges plan and reduces its surplus
- Buyer gets full use of all capital

Transactions – In general

- Benefit security of utmost importance
- Good social use – money stays in plans
- Keeps unhealthy plans off PBGC roles
Transactions – In general

- Evaluate value of forgone deductions
- Seller must consider capital gains tax
- Buyers with underfunding generally are tax exempt or have large accumulated NOL’s

Underfunded Plans
Underfunded Plans

• The role of Risk Transfer / Derisking
• What is underfunding?

Risk Transfer

• Risk Transfer transactions are transactions that transfer risk to another party
• Risks include investment risk, interest rate risk and longevity risk
  – including “mortality table” risk
• Risk Transfer transactions include
  – Annuity buyouts
  – Lump sum windows
Derisking Strategies

• Derisking strategies are strategies that lessen the risks assumed by the plan without transferring them to others
• Most common is a Liability Driven Investment strategy (LDI)
  – Plan invested in a manner to mimic a duration matched bond portfolio
  • Mitigates interest rate and investment risk as assets move in tandem with liabilities in response to rate changes

LDI

• Not an exact match
  – Duration is based on actuarial assumptions regarding commencement, longevity etc
  – Potential for failures among underlying portfolio
  – Plan cash flow may extend 60 years, no market for 60 year duration bonds
Risk Transactions and Underfunding

- Depending on the sponsor’s definition of well funded and their approach to closing funding shortfalls, risk transactions may help or hurt.
- Lump sum windows and annuity transactions are more expensive in absolute terms during low interest rate environments but may provide relative cost savings compared to carrying value.

Risk Transactions and Underfunding

- Consider a plan year in which interest rates have declined 50 bps since the previous December.
- Assume the plan has adopted a full LDI strategy.
- The plan has experienced asset growth as a result of the declining rates.
- Using a LS Window, the plan can settle the benefits via lump sum at the previous December rates.
  - The lump sum benefits are cheaper than the assets “dedicated” to those benefits.
  - Window generates a gain to the plan.
Risk Transactions and Underfunding

- Consider a sponsor whose funding strategy is a contribution regimen that will eventually fund the PVFB but always keep AFTAP above 80%
- Considering a LS Window
  - If the lump sum was exactly equal to the funding target associated with each benefit, the AFTAP would drop below 80% because you would be paying 100% of the FT to the members of the window
  - And, with AFTAP using HATFA rates and 417e rates unadjusted, the lump sum will surely exceed the carrying value of the benefit

Risk Transactions and Underfunding

- Considering a LS Window
  - To remain at 80% funded the employer would have to make a significant plan contribution, perhaps in advance of the window
Risk Transactions and Underfunding

• Is a LS window an amendment increasing benefits?
  – An amendment increases benefits if it causes an increase in the funding target
  – Standard method for determining this is to look at the effect of the amendment on the valuation results using the same assumptions used for the valuation
  – But if the plan did not provide for a lump sum benefit, the valuation would have assumed that no lump sums were taken
  – If using the same assumptions, the L-S window would have no effect on FT
  – No clear guidance on this (2009 gray book on ERW)

Risk Transactions and Underfunding

• Assume LS window is not an amendment increasing benefits
  – If the plan was at exactly 80% AFTAP
    • At next valuation the plan will be short of 80% due to
      – the difference between HATFA and 417e rates
      – The fact that 100% of the benefits were paid during the window from a plan that was only 80% funded
    • Will have to contribute for prior year to avoid restrictions
      – Cannot make a 436 contribution to remove a restriction on accelerated distributions
Risk Transactions and Underfunding

- While most LS windows will cause a funding loss due to the difference between HATFA rates and 417e rates
  - May result in a gain versus PBGC premium rates
  - Save PBGC per head premium
  - Reduce VRP cap by reducing headcount
  - Saves ongoing administrative expenses

Interest Environment

- It is not wholly unreasonable for sponsors to anticipate that interest rates will rise or that they will be able to earn their way back from underfunding
- Sponsors using this approach should steer clear of LS windows and annuity buyouts and other transactions that cause negative cash flow or lock in today’s inflated settlement prices
- Sponsors who have adopted LDI or other strategies which mitigate interest rate risk have already locked in the current settlement pricing
  - If interest rates go up, their liabilities and assets will decline in tandem, giving them no benefit from the increase in rates
What is Underfunding

• Underfunding is in the eye of the beholder
  • The plan sponsor
    – Ultimately responsible for funding the plan
  • Their auditors
    – Financial statement disclosures
  • Their bankers
    – Loan covenants etc
  • The IRS
    – Minimum funding, max deductions
  • The PBGC – Overall insurer

What is Underfunding

• Plan sponsor must consider all of the different parties in determining a funding strategy
• PPA works toward funding a proxy for termination liability over 7 seven years
  – Subject to the volatility of interest rates
• While PPA is the required minimum, sponsors may adopt funding policies based on other benchmarks to fit their goals
  – As long as the policy contribution exceeds the MRC
Significant Underfunding

• There are three basic strategies for significantly underfunded plans
  – Eliminate volatility, which locks in underfunding, and pay off shortfall systematically
  – Continue traditional investment regimen perhaps with a hedge against declines while rates rise
  – A blend of the above, with more assets moved to an LDI strategy as funding improves

Benchmarks

– Plan termination liability
– PBO basis /ABO basis
– Unadjusted rate FTAP > 100%, 80%
– Funding Rate AFTAP > 80%, 60%
– CL > 110%
Plan Termination Liability

• The ultimate benchmark
  – For frozen plans
    • Risk management principles almost beg that the plan be terminated when this milestone is reached
    • Settlement of benefits relieves employer of mismatch risk, administrative expenses, PBGC premiums etc
  – For active plans
    • Most often will move to LDI strategy, annuity buyout for retirees, LS window for VTs
    • Greatly lessens ongoing risk and expenses, matches plan cost to benefits earned

PBO basis /ABO basis

• While this basis should be a proxy for plan termination liability
  – Many employers use above median and even more select yield curves for valuing benefits for financial accounting
  – Result is that PBO/ABO are often significantly less than the cost to actually settle the benefits
Unadjusted rate FTAP > 100%, 80%

- Unadjusted rate funding target is a fairly good estimate of actual termination liability
  - Is readily available since it is calculated for PBGC 4010 gateway purposes
- Benchmark used to avoid 4010 reporting which kicks in for plans with underfunding > $15m and less than 80% on unadjusted basis

Funding Rate AFTAP > 80%, 60%

- The funding AFTAP post MAP-21 HATFA etc is, to some sponsors, a proxy for the plan’s termination liability when interest rates return to “normal”
- More realistically, used as a benchmark simply to avoid 436 restrictions on accelerated distributions and continued accruals
CL Funding % > 110%

- Used as benchmark in smaller plans to ensure the ability to pay lump sums to HCEs
- No clear definition of CL anymore
- IRS has allowed AFTAP (unadjusted), MAP-21 and HATFA AFTAPs as a surrogate for CL
- CL rates are still published
- What does your document say?

Corporate Transactions

- As discussed earlier, there is a marketplace for matching employers with overfunded plans and employers with underfunded plans
- Can allow sponsor to close shortfall at a cost of roughly 50 cents on the dollar
- Same result could be accomplished thru multiple employer plans if not for nexus requirement
Variable Annuity Conversions

• Plans with ongoing accruals may consider converting to a Variable Annuity Plan
• VAP’s adjust accrued benefits each year by multiplying by
  Accrued Bft x (1+ actual return)/(1+exp return)
• VAP adjustment applies to entire accrued benefit, with existing benefit subject to wearaway
• Eliminates investment risk (after a few years)

Variable Annuity Conversions

• May eliminate interest rate risk if Academy proposal is adopted
  – Practice note indicates that the way to value the benefits under a VAP is to value the benefits at the hurdle rate (expected return rate)
  – If adopted by IRS eliminates interest rate risk and volatility from these plans
    • Likely reduces funding cost