Workshop 23
Overfunded Plans

Presented by: Steven J. Levine, MSPA

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

IRS
DOL
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

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

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