30th Annual Tax Symposium

IS THERE SOMETHING WRONG WITH AN OVERFUNDED PENSION PLAN?

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WHAT'S A DEFINED BENEFIT PENSION PLAN?

The universe of retirement plans is divided into two types.

Defined Contribution Plans

- Profit sharing, 401(k) and money purchase plans
- Benefits determined by amount held in the participant's account

WHAT'S A DEFINED BENEFIT PENSION PLAN?

Defined Benefit Plans

- Traditional defined benefit plans, cash balance plans and social security
- Participants earn retirement benefits payable as of their retirement date
- Funded by an actuarial determination of the contribution amounts needed to maintain required levels of funding

WHAT'S A DEFINED BENEFIT PENSION PLAN?

Example of a traditional defined benefit plan

- 50% of final three year's average annual compensation reduced by 1/30th for each year of service less than 30, beginning at age 65.
- Joe retires at age 62. His last three years' average compensation is $90,000, and he worked for his employer for 20 years.
- Joe's annual retirement benefit starting at age 65 equals: ($90,000 x 50%) x (20 ÷ 30) = $30,000 per year

WHAT'S A DEFINED BENEFIT PENSION PLAN?

Example of a cash balance plan

- Participant's hypothetical account is credited with a hypothetical employer contribution of 5% of annual compensation plus a hypothetical rate of earnings on her hypothetical account of 4%
- Mary's annual compensation is $80,000 and her hypothetical account balance is $200,000
- Mary's hypothetical account increases by ($80,000 x 5%) + ($200,000 x 4%) = $12,000 for the year

HOW DOES A DEFINED BENEFIT PLAN BECOME OVERFUNDED?

Generally, it is a plan that has more assets than liabilities at any time.

Liabilities include:

- Operating expenses
- Current benefits owed to participants
- Future benefits earned but not payable until a later date

HOW DOES A DEFINED BENEFIT PLAN BECOME OVERFUNDED?

A plan's funding ratio is generally equal to its liabilities divided by its assets.

- If ratio is less than 100%, it is underfunded
- Ratios of greater than 80% are considered safe
- If ratio is greater than 100%, it is overfunded

HOW DOES A DEFINED BENEFIT PLAN BECOME OVERFUNDED?

Funding rules are designed to limit too much or too little being accumulated.

- If the plan is inadequately funded, it puts participants' benefits at risk
- If funding is too great, it allows plan sponsors to contribute and deduct excessive amounts and enjoy a tax-exempt environment for that excessive amount

HOW DOES A DEFINED BENEFIT PLAN BECOME OVERFUNDED?

Factors that may cause an overfunded plan

- Rising interest rates reduce the current value of benefits because less money is needed today for future benefits (the opposite is also true)
- Investment returns that exceed projected returns

WHAT'S GOOD ABOUT AN OVERFUNDED PLAN?

From the plan sponsor's perspective:

- Funding "cushions" provide flexibility by reducing or even eliminating contributions when cash is needed
- The failure to contribute required minimum amounts determined by the plan's actuary can trigger excise taxes of 10% to 100% under IRC §4971

WHAT'S GOOD ABOUT AN OVERFUNDED PLAN?

From the participant's perspective:

- Peace of mind knowing their benefits will be paid at retirement
- The PBGC may not be the "safety net" that is expected

From the federal government's perspective

- The PBGC serves as the insurer for many plans
- There is increasing concern over the agency's solvency

WHAT'S BAD ABOUT AN OVERFUNDED PLAN?

- For ongoing plans, generally not a problem
- IRC §4972 imposes a 10% excise tax on nondeductible contributions
- The biggest problems occur when an overfunded plan is terminated
- What can be done with excess assets?
  - Increase participants' benefits, and/or
  - Revert to the plan sponsor

WHAT'S BAD ABOUT AN OVERFUNDED PLAN?

What happens when excess assets fund additional benefits?

- They must be allocated in a non-discriminatory manner
- Plan owners may not share if they are capped out by the IRC §415 limit
- Substantially all of the excess assets are allocable to the non-owners

WHAT'S BAD ABOUT AN OVERFUNDED PLAN?

How does IRC §4980 apply to reversions?

- In addition to being subject to income tax, a reversion of excess assets is also generally subject to a 50% excise tax
- The excise tax is reduced to 20% if at least 20% of the excess assets are used to provide participants with additional non-discriminatory benefits
- The excise tax is also reduced to 20% if at least 25% of the excess assets are transferred to a Qualified Retirement Plan ("QRP")

WHAT’S BAD ABOUT AN OVERFUNDED PLAN?

What is a QRP?

- A new or existing defined contribution plan
- At least 95% of the participants that remain as employees must be participants in the QRP
- The transferred assets must be held in a suspense account and allocated to participants in no longer than 7 years

HOW TO FIX AN OVERFUNDED PLAN

For ongoing plans

- Monitor the funding status
- Show restraint when the actuary gives you a funding range
- Look at your investment philosophy
- Buy life insurance in the plan

HOW TO FIX AN OVERFUNDED PLAN

For a plan that will be terminated:

- Increase plan benefits
- Increase compensation for key employees
- Don’t terminate it (yet)
- Pay plan expenses from plan assets

HOW TO FIX AN OVERFUNDED PLAN

For a plan that will be terminated:

- Return to the plan sponsor “mistaken contributions” or nondeductible contributions
- Expand coverage to bring in new participants
- Establish a QRP
- Acquire annuities to pay benefits
- Sell the company with the overfunded plan

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THANK YOU

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