IS THERE SOMETHING WRONG WITH AN OVERFUNDED PENSION PLAN?

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I. WHAT IS AN OVERFUNDED DEFINED BENEFIT PLAN ("ODB PLAN")?

A. What is a defined benefit plan?

1. The universe of retirement plans is divided into:

a. Defined contribution plans ("DC Plans")

i. A DC Plan is also referred to as an individual account plan.

ii. Each participant's benefits is determined by the amount held in their individual account.

iii. Sources include employer contributions, participant contributions and plan earnings.

iv. Under current law, there are no limits on the amount that may be paid to the participant from those plans.

v. Examples of DC Plans include profit sharing plans, 401(k) plans and money purchase pension plans.

b. Defined benefit pension plans ("DB Plans").

i Instead of being paid the amount held in their account, a participant is paid a benefit that is determined by a formula contained in the plan. The plan also specifies the period of time and frequency of the benefit payments.

ii. The funding of a DB Plan is generally done by the actuary who will take into account such factors as the following:

(a) Compensation of participants

(b) Plan's benefit formula

(c) Age of the participants and proximity to retirement

(d) Number of years of current service of the participants

(e) Number of years of service the participants will have at their retirement age

(f) Historical rates of investment return

(g) Projected rates of future investment returns

(h) Rates of turnover among participants

(i) Morality rates

c. Common examples of DB Plans:

i. Traditional DB Plans utilize formulas that take into account such factors as final average compensation; years of service, specified dollar amounts or percentages of earnings. For example:

(a) 50% of final average annual compensation reduced by 1/30th for each year of service less than 30.

(b) $100 per month for each year of service up to a maximum of 35 years.

ii. In more recent years, cash balance plans have become much more common.

(a) These are considered hybrid plans because they have elements of both DB Plans and DC Plans.

(b) Participants are given a hypothetical account that is credited with (i) a hypothetical employer contribution each year (i.e., 5% of their compensation or a flat dollar amount - $5,000), and (ii) a hypothetical rate of earnings (i.e., a specified rate such as 5% or an indexed rate that varies from year to year such as one tied to Treasury Bills or the S&P 500).

(c) The participant will then receive their hypothetical account balance (often in a lump sum) at their retirement date or employment termination date, regardless of the actual investment return earned by the plan.

B. How does a DB Plan become "overfunded"?

1. Generally, an overfunded pension plan is a DB Plan that has more assets than liabilities at any given time. Liabilities include:

   a. Plan operating expenses (this is generally very minor);

   b. Current benefits owed to plan participants; and

   c. Future benefits that have been earned but are not payable until a later date;

2. How well a DB Plan is funded is measured by the calculation of its funding ratio.

   a. The funding ratio is calculated by dividing the total benefits that are due to be paid by the plan's current assets.

   b. If a plan's funding ratio is less than 100%, the plan is underfunded.

      i. Many plans are underfunded.

      ii. Plans with funding ratios of 80% and above are still considered to be "safe."

   c. If a plan's funding ratio is more than 100%, the plan is overfunded.

      i. Many plans are overfunded.

      ii. While an overfunded plan may not seem to be problematic (and actually has some benefits), the degree of overfunding and the remaining life of the plan may change that conclusion.

3. How are contributions to a DB Plan calculated?

   a. Through a complex set of rules established by the IRS, the plan's actuary takes into account such factors as:

      i. The amount of benefits earned by the plan's participants, and

      ii. A protected rate of earnings for the plan to calculate an acceptable contribution amount or a range of acceptable contribution amounts.

b. These rules are designed to limit (to the extent possible) too much or too little being accumulated in the plan.

i. If the contribution is inadequate, it puts plan participants at risk for their promised benefits.

ii. If the contribution is too large, it allows plan sponsors to contribute and deduct artificially large amounts which enjoy the benefit of growing in a tax exempt environment.

4. What are the most likely factors that create an overfunded plan?

a. A change in interest rates used to calculate the cost of benefits.

i. With rising interest rates, the current value of future benefits decline and presumably less money is needed today for calculating the plan's liabilities.

ii. The opposite is also true in an environment of falling interest rates.

b. Unexpected turn-over among participants with unvested benefits

c. Investment returns that exceed projected returns.

i. This is the easiest factor to understand. If the actuary projects a 5% return and the plan earns a 10% return, excess assets have been created.

ii. In most cases, either future contributions are adjusted or investment returns level out so its not a big problem.

iii. It only becomes a problem if there are significant investment gains, continuing over long periods, without the actuary making adjustments to the continuing contributions levels.

iv. This has not been unusual over the last 12 months with the historic run up of the stock market we've come through.

II. <u>WHAT'S THE PROBLEM WITH AN ODB PLAN</u>?

A. Is there anything good about an ODB Plan?

1. From the plan sponsor's perspective:

a. DB Plans are subject to a complicated set of rules designed to ensure that plans are adequately funded and participants receive promised benefits.

b. These rules are generally administered by the plan's actuary, who develops minimum contribution requirements in accordance with standards enforced by the IRS.

c. A plan sponsor's failure to contribute sufficient amounts in a timely manner can lead to excise taxes under IRC§4971(b) (10% of the "funding deficiency") which can be increased to 100% under certain circumstances.

d. An ODB Plan will provide the plan sponsor with a "funding cushion" and the flexibility to reduce or even eliminate contributions in years where either:

   i. Cash is needed for other purposes, or

   ii. They are struggling through a tough economic period.

2. From the plan participant's perspective:

   a. Participants will have some peace of mind knowing that their promised retirement benefit will be there when they are ready to retire.

   b. While many DB Plan participants' retirement benefits are insured through the PBGC, it is not a guarantee that they will receive some or all of their promised benefits.

      i. There are limits on the amount of benefits that are guaranteed.

      ii. Some DB Plans are exempt from coverage (i.e., plans maintained by personal service organizations).

      iii. Employers can simply decide the funding obligations are too great and either freeze benefits at their current level or even terminate the plan.

3. From the perspective of the federal government:

   a. Even the federal government has an interest.

   b. To the extent that plans are unable to pay promised benefits, the obligation falls on the PBGC.

   c. We constantly see stories about deficient DB Plans being taken over by the PBGC and the risk of the PBGC'S own solvency.

B. What's so bad about an ODB Plan?

1. For ongoing plans, an overfunding is generally not a problem:

   a. See the analysis above.

   b. There is, however, another excise tax under IRC §4972 imposed on nondeductible contributions to qualified pension plans that might come into play.

      i. The plan's actuary may determine that the plan is so well funded that no contribution may be made, and to the extent a plan still contributes, it will be nondeductible.

      ii. IRC §4972 additionally imposed a 10% per annum excise tax on the nondeductible portion of the contribution until the excess amount becomes deductible or is returned to the plan sponsor.

2. The big problem with an ODB Plan generally occurs when the plan is terminated.

   a. At the time of a plan termination, excess assets from an ODB Plan can be used to:

      i. Increase benefits for plan participants,

      ii. Revert to the plan sponsor, or

      iii. Be used for both options under (i) and (ii).

   b. The plan document must dictate which option or options will be used.

   c. Many DB Plans simply provide that if there are excess assets after participants have been paid the promised benefits, the excess assets will be allocated among participants in a "non-discriminatory manner".

      i. This may be a reasonable approach. However, in a small plan it may be problematic.

      ii. The owner(s) of the plan sponsor may not be able share in the excess assets if they are capped by the Section 415 limit.

      iii. Substantially all of the excess assets may be allocated to benefits for the nonowner(s).

   d. The other option is to revert the excess assets to the plan sponsor; however, the amount reverted becomes taxable and is subject to the 50% excise tax under IRC §4980.

i. Depending upon the income tax rate of the sponsor, any state tax consequences and the excise tax, the combined tax "hit" can reach 75% or more.

ii. As the combined rates approach a confiscatory tax, other options must be explored.

3. How does IRC §4980 work?

a. A 50% percent excise tax will be imposed on the amount reverted to the plan sponsor, unless an exception applies.

b. The excise tax will be reduced from 50% to 20% if either exception applies:

i. The plan sponsor provides for certain minimum increased benefits for participants, or

ii. The plan sponsor establishes a Qualified Replacement Plan ("QRP").

c. To meet the increased benefits exception:

i. 20% or more of the excess assets must be used to provide additional benefits allocated among participants in a "nondiscriminatory" manner.

ii. This requires the allocation of excess assets to comply with the nondiscriminatory rules contained in IRC §410(b) and 401(a)(4).

iii. In most instances this is simply done by uniform proportionate increases, but other methods also may be utilized.

d. To meet the QRP exception:

i. At least 95% of the participants in the terminated plan that remain as employees must be participants in the QRP.

ii. At least 25% of the excess assets must be transferred to the QRP.

iii. Either a new plan or an existing DC Plan may be utilized.

iv. The transferred excess assets must be held in a suspense account and allocated to participants no less rapidly than ratable over a seven (7) year period.

e. Note that there will be no excise tax if all of the excess assets are transferred to a QRP.

III. WHAT ARE THE OPTIONS TO FIX AN ODB PLAN?

A. For an ongoing plan, be proactive.

1. Monitor the funding status of the plan at least once a year.

a. Consult with the Plan's actuary and investment advisor to consider current and projected future funding levels.

b. Waiting until the termination of the plan may be too late.

2. Don't automatically fund the maximum deductible amount.

a. It's understandable that a plan sponsor wants to maximize funding, if possible, when "times are good." It's also understandable that "tax shelter plans" are designed to save current income taxes.

b. If the plan is too aggressively funded, it may turn out to be counterproductive at the time of termination.

3. Consider an investment philosophy for a DB Plan that is on the "conservative side" where there won't be large swings in investment returns.

a. If the company maintains both a DB Plan and a DC Plan, skew investments on the aggressive side in the DC Plan because there are no "penalties" for either wildly successful investment results or significant losses from poor investment returns.

b. With regard to the company's DB Plan, stable or consistent returns will help protect against overfunded plans or wide swings in funding requirements, particularly in years where contributions by the plan-sponsor may be a challenge.

4. Acquire life insurance within the plan.

a. You can increase costs by acquiring life insurance in the plan and insuring "large death benefits."

b. Insurance policies often have low cash values in early years.

c. Keep in mind the IRS is cognizant that some life insurance policies have been designed with "springing cash values" where the policy's early values are artificially low.

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B. For a terminating plan:

1. Increase plan benefits.

a. When possible, the simplest approach is to increase plan benefits.

i. Can be done by changing the benefit formula.

ii. Alternatively, can be done by allocating the excess in a "nondiscriminatory" manner.

b. This technique may work as long as:

i. The owners of the plan are not already capped by the Section 415 limit, or

ii. The cost of increasing benefits doesn't exclusively or even primarily inure to non-owners.

2. Increase compensation for certain key employees.

a. Plans that base benefits on average compensation may be able to create substantially increased benefits for certain key employees by simply increasing salaries or bonuses in the year before or even the year of the plan termination.

b. This becomes even more attractive if the employee is over the social security wage base.

3. Keeping the plan open and not terminating it.

a. Amounts that may be paid for owners and key employees may increase to use up excess assets.

b. The increases may be due to:

i. Cost-of-living increases to Section 415 limit.

ii. An increased Section 415 limit due to more years of participation. A full Section 415 limit may not be available until a participant has ten (10) years of participation.

iii. Increasing average compensation as described in Paragraph 2(a) above.

4. Paying plan expenses from plan assets.

    a. This may be done as long as the plan document permits the payment of expenses.

    b. The types of expenses that may be paid include:

        i. Certain legal fees.

        ii. Accounting and auditing fees.

        iii. Actuarial fees.

        iv. Investment fees.

        v. TPA fees.

        vi. Bonding fees.

5. Returning to the plan sponsor amounts that were "contributed in error" or were "determined to be non-deductible" by the IRS.

    a. These situations are rare but should be explored with the plan's actuaries, attorneys, etc.

    b. The plan document must contain a provision authorizing this.

6. Hiring new employees or expanding coverage to bring in new participants.

    a. This may mean adding spouses or other family members

    b. Some family members may not be receiving payroll due to payroll tax considerations, but adding them to the payroll or increasing their compensation may be an effective way to deal with excess assets.

    c. Simply reducing a service requirement from 1,000 hours a year to 100 hours a year may do this.

    d. Keep in mind the compensation paid to the family member (or other key employee) must be "reasonable."

7. Establish a QRP.

    a. What is a QRP?

        i. An existing or newly created retirement plan of the plan sponsor.

        ii. At least 95% percent of the active participants in the terminated plan who remain as employees are participants of the QRP.

iii. Prior to any reversion to the plan sponsor, at least 25 of the excess assets must be transferred to the QRP.

iv. The entire excess amount may actually be transferred to the QRP.

v. If the QRP is a defined contribution plan, the transferred amount must be allocated to participant accounts over no more than a seven (7) year period.

b. What are the consequences of using a QRP?

i. The amounts transferred to the QRP are not taxable to the plan sponsor.

ii. It's not treated as a reversion.

iii. The excise tax on any remaining excess asset is reduced from 50% to 20%.

8. Acquire annuities to pay benefits on termination.

a. Excess assets are reduced or eliminated in some cases, through the use of annuity policies to fund retirement benefits.

b. This could occur due to large upfront costs including the payment of large commissions to insurance agents or low interests rates paid on the annuity products.

9. Sale of the company maintaining the ODB Plan.

a. An ODB Plan in some cases represents an "off-balance sheet asset."

b. While the existing owners of the plan sponsor may have no further use for the plan and excess assets due to their impending retirement or being capped by Section 415, another business owner may find the ODB Plan attractive.

c. A strategic sale of the stock of the plan sponsor to a new owner, may give that new owner:

i. An opportunity to merge the overfunded plan into their underfunded plan.

ii. The opportunity to use the overfunded plan to bear the costs of accruing benefits for the new owners and their employees if they want to establish or enhance a new or existing DB Plan.

d. This scenario can lead to a win-win situation.

   i. The current owners of the company can recognize far more personal benefit than they would with a reversion of the excess assets.

   ii. The acquiring owners can derive substantial amounts for funding future benefits at a "negotiated discounted amount."