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Terminating an Overfunded Pension Plan? Who Gets the Excess?

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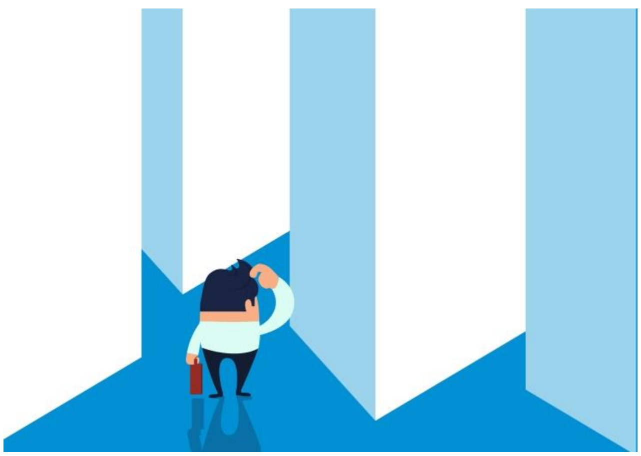
If an overfunded single employer pension plan is terminating and its participants and beneficiaries are on track to receive full benefits, the plan sponsor will likely ask if the excess is theirs. In other words, will the surplus revert to the plan sponsor? The answer is maybe.

To determine how excess plan funds can be exhausted, which may include a reversion to the plan sponsor, there are 7 possibilities to consider. As always, the place to start with any retirement plan issue is to answer the question: what does the plan say?



Possibilities to Consider if the Terminating Plan Document does not Permit a Reversion

A plan document may state that no part of the plan's assets can be diverted for any purpose other than for the exclusive benefit of participants and beneficiaries. The plan may also indicate that the plan cannot be amended to designate any part of the assets to become the employer's property. If an overfunded defined benefit plan has these provisions, it is tempting to assume the only choice is to allocate the excess among participants and beneficiaries. However, even in the face of these explicit provisions, there may be other provisions that permit an employer to recover or use a portion of the excess assets.

Possibilities 1 and 2 – Return of Mistaken and Nondeductible Contributions

Plan documents generally indicate that if an employer makes an excessive plan contribution due to a mistake, the employer can demand the surplus is returned. The employer is required to request this from the trustee within one year after the contribution was made to the trust. In addition, plans generally provide that a contribution is made on the condition that the employer receives a corresponding tax deduction. In the unlikely event that the deduction is not permitted by the IRS, the contribution can be returned to the employer within one year following the IRS' final determination that the tax deduction was not allowed.

An example of a contribution mistake may be an actuarial calculation error. In a 2014 Private Letter Ruling, the IRS considered a surplus reversion when a terminating single employer plan purchased an annuity contract. The excess assets were created when the purchase price selected to fully fund plan benefits actually came in at a lower price than estimated. Using reasonable actuarial assumptions, the plan's actuary had advised the employer to contribute a higher amount than was ultimately calculated as necessary by the insurance company. In this case, the IRS permitted the return of the mistaken excess contribution.

Possibility 3 – Have all Reasonable Plan Expenses Been Paid from the Trust?

Many plan documents provide that plan expenses can be paid from the trust. In some instances, appropriate and reasonable plan termination expenses will go a long way to exhaust excess assets. Reasonable plan termination expenses include determination letter costs and fees, service provider termination charges and termination implementation charges such as those for the plan audit, preparing and filing annual reports, calculating benefits, and preparing benefit statements.

Possibilities to Consider if the Terminating Plan Document Permits a Reversion

The overfunded plan may explicitly state that excess assets, once all of the plan's obligations to participants and beneficiaries have been satisfied, may revert to the plan sponsor. On the other hand, the plan may not explicitly permit a reversion. In that case, the plan sponsor may want to consider amending the plan to allow a reversion well ahead of the anticipated termination.

Possibilities 4 – Take a Reversion

If the first three possibilities do not work or are inadequate to exhaust the surplus, and the overfunded plan allows a reversion, there are three more possibilities. In the first, the employer takes all. The employer can take all of the excess funds back subject to a 50% excise tax, as well as applicable federal tax. Notably, a not-for-profit organization may not be subject to the excise tax on the reversion at all if it has always been tax-exempt.

Possibility 5 – Transfer the Excess to a Qualified Replacement Plan

The opportunity to pay only a 20% excise tax (and any applicable federal tax) on part of the surplus is available where the remaining excess assets are transferred from the terminating pension plan to a newly implemented or preexisting qualified replacement plan (QRP). A QRP can be any type of qualified retirement plan including a profit sharing plan, 401(k) plan, or money purchase plan. For example, an employer's or a parent company's 401(k) plan, whether newly implemented or preexisting, may qualify as a qualified replacement plan. Once an appropriate plan is chosen, the amount transferred into the QRP must be allocated directly into participant accounts within the year of the transfer or deposited into a suspense account and allocated over seven years, beginning with the year of the transfer.

There are additional requirements for a qualified replacement plan. At least 95% of the active participants from the terminated plan who remain as employees must participate in the QRP. In addition, the employer is required to transfer a minimum of 25% of the surplus into a qualified replacement plan prior to the reversion. If all of the QRP requirements are satisfied, then only the amounts reverted to the employer are subject to a 20% excise tax and federal tax, if applicable.

Possibility 6 – Provide Pro Rata Benefit Increases

If the employer chooses not to use a QRP, it can still limit the excise tax if it takes back 80% or less of the surplus and provides pro rata or proportionate benefit increases in the accrued benefits of all qualified participants. The amendment to provide the benefit increases must take effect on the plan's termination date and must benefit all qualified participants. A qualified participant is an active participant, a participant or beneficiary in pay status, or a terminated vested participant whose credited service under the plan ended during the period beginning 3 years before termination date and ending with the date of the final distribution of plan assets. In addition, certain other conditions apply including how much of the increases are allowed to go to participants who are not active.

A Possibility That's Always Available

Possibility 7 – Allocate all of the Excess Among Participants and Beneficiaries

It is always possible to allocate all of the excess assets among participants in a nondiscriminatory way that meets all applicable law. A plan amendment is necessary to provide for these higher benefits.

You may know at the outset of terminating your plan that there will be excess assets. On the other hand, a surplus may come as a surprise. Even if a pension plan is underfunded at the time the termination process officially begins, it is possible that the plan becomes overfunded during the approximate 12 month time period to terminate the plan. In this scenario, the plan sponsor will have to address what to do with the excess assets.

Dealing with the excess assets in a terminating defined benefit plan can be a challenge. There are traps for the unwary, and considerations beyond the scope of this article. Plan sponsors need to determine first how the excess was created, because the answer to that question may determine what happens to it. If there is no obvious answer in how to deal with the surplus, then the plan sponsor needs to look at all of the possibilities. It may be that a combination of uses for the excess plan assets is best. If you think you will find yourself in this situation with your defined benefit plan, consult your trusted advisors at your earliest opportunity so that you know the possibilities available to you.

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