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# Working With Overfunded Pension Plans

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While Congress, plan sponsors, and the retirement industry have (rightfully) devoted most of their attention to underfunded pension plans, many pension plans are or could soon be overfunded. Sponsors are not quite sure what to do with overfunded pension plans. Many mistakenly believe that the hefty reversion tax is inevitable and that the only way to minimize it is to sponsor a qualified replacement plan. This article will explore some of the causes of overfunding in pension plans as well as some ways in which the plan sponsors can take advantage of the overfunded plans without having to pay the reversion tax or maintain a qualified replacement plan. Possibilities explored in this article include:

- Plan mergers;
- Use of surplus to pay for corporate mergers and acquisitions;
- Replacement of severance benefits for certain mass layoffs; and
- Replacement of retiree medical benefits and employer contributions to 401(k) plans.

## SOME CAUSES OF OVERFUNDED PLANS

Plans can become overfunded for a variety of reasons, such as good investments, plan accrual freezes, extra contributions in profitable years, etc. With the high interest rates in the 1980s and investment returns in the 1990s, it was not uncommon to see overfunded pension plans. As interest rates declined, and in the wake of the market crashes in 2001 and 2008, overfunded pension plans seemed to disappear and attention went to underfunded plans. However, a confluence of events has led to a resurgence of overfunded pension plans.

## Pension Protection Act of 2006

The funding rules prior to the Pension Protection Act of 2006 (PPA) required defined benefit plans to fully fund any funding shortfall over 30 years.[1] The PPA dramatically changed the definition of a funding shortfall by lowering the interest rate used in the calculation and increasing the calculated liability. The PPA also changed the amortization period to seven years, effective for plan years beginning after 2007.[2] In response to the Great Recession and historically low interest rates, in 2010 Congress allowed certain plan sponsors to amortize underfunding over 15 years or to pay interest for two years and then amortize the principal over the following seven-year period.[3] That relief was available only for plan years beginning in 2008 through 2011. Further, there were limitations on compensation to executives of plan sponsors who elected this relief. Consequently, not many plan sponsors elected this relief.

In addition to increasing the minimum required contribution, the PPA also increased the maximum tax-deductible contribution. Generally, the PPA increased the tax-deductible limit to the plan year's normal cost, plus the amount needed to fully fund the li-

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[1] Former Code §412(b)(2)(B). For plans in existence on January 1, 1974, underfunding could be amortized over 40 years. All references to "Code" sections are to the Internal Revenue Code of 1986, as amended.

[2] Code §430(c).

[3] Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, 111 Pub. L. No. 192, §201(b), 124 Stat. 1280, 1290–91 (2010).



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ability, plus an additional cushion of 50% of the liability and any anticipated increase in liability due to future increases in compensation. Now plan sponsors could fund up to 150%, dramatically increase their contributions to pension plans, and still get a tax deduction.

The combination of increased minimum-required contributions and higher maximum tax-deductible contributions led to increased cash flows into qualified defined benefit plans.

## Rising Stock Market

The U.S. stock market has done exceedingly well in recent years. From March 2009 until February 2020, the United States experienced the longest bull market in history, with the S&P 500 Index rising 400%. After a brief bear market period from February 19, 2020 until March 23, 2020 due to the coronavirus pandemic, the S&P 500 Index surged more than 100% as of March 2022. Although the index later fell substantially mostly due to the Federal Reserve's raising of interest rates to tame inflation, its annualized five-year return is still 9.46%.[4]

Even with various de-risking strategies, such as glidepath and asset liability matching, U.S. pension plans maintain significant investments in equities. Thus, the rising stock market improved the funded status of U.S. pension plans.

## Rising Interest Rates in 2022

While the stock market has fallen since March 2022, interest rates have increased. The higher the interest rates used to discount pension cash flows, the lower the liability.

The discount rate as of February 28, 2023, for an average plan[5] based on the Mercer Yield Curve was 5.17%, up from 3.43% as of February 28, 2022.[6] The Mercer Yield Curve is derived from corporate bonds rated Aa or higher by either Moody's or Standard & Poor's. For a plan with a typical plan population, the change in discount rates from February 28, 2022, to February 28, 2023, would be expected to lower the liability by 26.10%.[7]

The discount rate increase has had a bigger impact on funded status than the drop in the stock market. A study by PNC found that the funded status of the average pension plan increased during 2022 due to the increase in discount rates, which more than offset the drop in asset values.[8]

## Rising PBGC Variable Rate Premiums

Since 2014, Congress has consistently raised the Pension Benefit Guaranty Corporation (PBGC) variable-rate premium (VRP). Unlike PBGC flat-rate premiums, VRPs are dependent on the funded status of the plan. Until 2013, employers paid $9 in VRP to the PBGC for every $1,000 of unfunded vested benefits (UVB). However, the Moving Ahead for Progress in the 21st Century Act (MAP-21) changed the VRP to $14 per $1,000 of UVB for single-employer plans for plan years beginning in 2014. MAP-21 also required that the VRPs be automatically adjusted for inflation each year. For plan years beginning in 2023, the VRP is $52 per $1,000 of UVB, capped at $652 times the number of participants. The SECURE 2.0 Act of 2022 [9] eliminated future indexing, so the VRP will not increase in 2024 or later unless Congress removes the limit. Regardless, the VRP rate is now more than five times the rate in 2013 without regard to the cap. Further, while MAP-21 raised interest rates through stabilization for funding and benefit restriction purposes, it required that UVBs continue to be calculated using the lower non-stabilized interest rates. The higher premium burden led some employers to reduce the UVB by increasing contributions to the plans. Given that UVB is calculated on a non-stabilized basis, the plans have become even better funded on a stabilized basis.

## Tax Cuts and Jobs Act of 2017

Before 2018, the corporate tax rate ranged from 15% to as high as 39% based on a corporation's taxable income, with the highest rate kicking in at $100,000. However, the Tax Cuts and Jobs Act (TCJA)[10] changed the corporate rate to a flat 21% for tax years beginning after December 31, 2017. For most corporations sponsoring defined benefit plans, that meant the tax rates were lower in 2018 than in 2017. For such corporations, tax-deductible pension contributions yielded a higher deduction in 2017 than in 2018 or later years. Therefore, those sponsors had

[4] As of March 16, 2023.

[5] An average plan represents a sample pension plan with a typical mix of actives and retirees with a duration of 15-20. Duration of a plan is defined as the percentage change in liability due to a 1-percentage-point change in the discount rate.

[6] *Pension Discount Yield Curve and Index Rates in US*, Mercer (Mar. 3. 2023), https://www.mercer.us/our-thinking/wealth/mercer-pension-discount-yield-curve-and-index-rates-in-us.html.

[7] The liability reduction for a plan with a duration of 15 for a discount rate change from 3.43% to 5.17% would be 15 × (5.17% − 3.43%) = 26.10%.

[8] Kimberlene Matthews, *Key Considerations for 2023*, PNC (Jan. 12, 2023), https://www.pnc.com/insights/corporate-institutional/manage-assets/pension-risk-spotlight1.html.

[9] Division T of the Consolidated Appropriations Act of 2023, Pub. L. No. 117-328 (Dec. 29, 2022).

[10] Pub. L. No. 115-97 (Dec. 22, 2017).



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an incentive to make more than the required contributions in 2017. This was particularly appealing to corporations during 2018, when they could put money into their pension plans using 2018 cash flow taxed at 21% and deduct it for 2017 with a deduction worth 39%. Many employers took advantage of the higher deduction in 2017, thus further contributing to higher rates of overfunded plans.

## THE PROBLEM WITH OVERFUNDED PLANS

The problem with overfunded plans is that sponsors cannot easily take the excess assets and put them to some other use. Once a contribution has been made to a plan, it cannot be removed from the trust, except in very limited circumstances.

### Exclusive Benefit Rule

Both the Employee Retirement Income Security Act of 1974, as amended (''ERISA''), and the Code require that a pension plan be maintained for the exclusive benefit of the participants and beneficiaries.[11] So, generally, once an employer has made contributions to the plan, the employer cannot get them back. There are very few exceptions to this rule. One exception is if the contribution was made due to a mistake of fact.[12] This mistake-of-fact exception has been narrowly construed to include clerical or actuarial errors.[13] Some other exceptions include contributions that were expressly conditioned on the initial qualification of the plan if the plan fails to receive a determination letter reflecting such qualification, and contributions conditioned on their deductibility to the employer if the deduction is disallowed.[14]

### Plan Termination

The exclusive benefit rule does not prohibit returning excess assets to the employer if the plan has been terminated and all liabilities have been satisfied.

However, excess assets that revert to the employer after the satisfaction of all liabilities are subject to a 50% excise tax on the reversion.[15] Employer reversion specifically excludes any amounts that could be returned under Code §401(a) prior to plan termination or any amounts includible under Code §401(a)(2), such as contributions returned due to mistake of fact, failure of the plan to initially qualify or failure of the contributions to be deductible.[16]

The excise tax could be reduced to 20% in one of two scenarios. One, the employer may amend the terminated plan to provide increased accrued benefits so that they have an aggregate present value of at least 20% of the surplus assets.[17] The net effect of this is that $100 of surplus turns into $47.20 of cash[18] for the corporation, which must pay any applicable state income tax.

Alternatively, the employer could establish or maintain a qualified replacement plan, which is a qualified plan whose active participant population includes at least 95% of the terminated plan's active participants who remain as employees of the employer.[19] A qualified replacement plan must have a direct transfer of assets from the terminated plan in an amount equal to the excess of 25% of the maximum excess assets over the present value of any increases in the accrued benefit under the terminated plan adopted during the 60-day period ending on the termination date. The Code lays out requirements on the allocation of assets transferred to the qualified replacement plan that is a defined contribution plan. If at least 25% of the excess assets are transferred to a qualified replacement plan, the amount transferred would be exempt from the excise tax, with the remainder taxed at the reduced rate of 20%, plus the ordinary income tax of 21%.[20] The net effect of this is that $100 of surplus turns into $44.25 of cash[21] for the corporation, which must pay any applicable state income tax. A plan sponsor can fully escape taxation by transferring *all* the excess assets to a qualified replacement plan, but that leaves the corporation with no cash at all from the surplus.

While terminating a plan and transferring the excess assets to a qualified replacement plan is one way to use the excess assets while avoiding a reversion, there are other ways to take advantage of the excess assets *without* terminating a plan.

The rest of this article explores those ways.

## POTENTIAL WAYS TO USE EXCESS ASSETS

### Plan Mergers

One relatively simple way of taking advantage of excess assets is by merging the overfunded plan with

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[11] ERISA §403(c)(1); Code §401(a).

[12] ERISA §403(c)(2)(A)(ii); Code §401(a)(2).

[13] PLR 201228055 (Feb. 25, 2011), PLR 201839010 (June 28, 2018).

[14] ERISA §403(c)(2)(B), §403(c)(2)(C).

[15] Code §4980(d).

[16] Code §4980(c)(2).

[17] Code §4980(d)(1).

[18] ($100 − $20) × (1 − 21% − 20%) = $47.20.

[19] Code §4980(d)(2)(A).

[20] Rev. Rul. 2003-85, 2003-2 C.B. 291.

[21] ($100 − $25) × (1 − 21% − 20%) = $44.25.



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an underfunded plan in the same controlled group. By merging the two plans, the employer will not have to make additional contributions (or will have to make less contributions) to the underfunded plan. So the merger effectively acts as a reduction in future contributions to the underfunded plan and also may reduce PBGC premiums.

As with any plan merger, the employer will have to comply with Code §414(l), which dictates the rules governing the mergers of qualified plans. Each participant in both plans must receive a benefit immediately after the merger (on a termination basis) at least equal to the benefit he or she would have received immediately prior to the merger (also on a termination basis). Benefits on a termination basis means benefits provided under ERISA §4044.[22] That means assets will need to be allocated pursuant to priority categories under ERISA §4044. If the merged plan's assets would at least equal its liabilities (on a termination basis), Code §414(l) would be satisfied. If, however, the assets would be less than the liabilities, some participants from the overfunded plan would be worse off in the merged plan if they fall in a lower priority category under ERISA §4044 than the lowest priority category that is fully funded in the underfunded plan. Therefore, in those instances, a special schedule of benefits would need to be maintained to ensure that no participant is worse off.[23]

In addition to Code §414(l) considerations, all optional forms of benefits and vesting schedules will need to be protected. A Form 5310-A must be filed at least 30 days prior to the effective date of the plan merger unless it is a de minimis merger.

## Corporate Transactions

*Use of Surplus to Pay for Mergers and Acquisitions*

Corporate transactions could present a unique opportunity to put surplus pension assets to good use.

A corporate merger or acquisition could be followed with a merger of pension plans. Suppose Company A, which sponsors an overfunded plan, acquires Company B, which sponsors an underfunded pension plan, in a stock transaction. *The amount of the underfunding is taken into account in the purchase price*. The underfunded plan merges with the overfunded plan. The merged plan would become less overfunded, but Company A would have received the value of the reduction in overfunding in the form of a reduced purchase price of Company B. As with any merger, compliance with Code §414(l) will be required.

*Transfers*

Another way to get the value of a plan's overfunding in a corporate transaction could involve a transfer of just the liabilities from an underfunded plan to the overfunded plan. Assume Company A, with an overfunded plan, acquires in an asset transaction Company B, which sponsors an underfunded plan. Since this is an asset transaction, the parties can agree that Company B will retain the underfunded pension plan. However, following the corporate transaction, a portion of the liabilities from Company B's plan are transferred to Company A's plan, and the amount of that liability would be reflected in the purchase price. This leads to the question of whether a liability-only transfer is permitted under Code §414(l). The statutory language says that the answer is yes. The text says that ''in the case of any transfer of assets *or* liabilities . . . each participant in the plan would (if the plan then terminated) receive a benefit immediately after the . . . transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the transfer (if the plan had then terminated).'' (emphasis added). So Code §414(l) says that a transfer of just the liabilities is permissible as long as no participant is worse off.

According to the IRS regulations, a transfer of assets or liabilities is a combination of a spinoff from the transferor plan and a merger into the transferee plan.[24] The regulations further say that in the case of a spinoff, Code ''section 414(l) will be satisfied if'' (1) all of the accrued benefits are allocated to one of the plans, and (2) the value of the assets allocated to each of the spun-off plans is not less than the sum of the present value of the benefits in the plan before the spinoff for all participants in that spun-off plan.[25] While this regulation suggests that a transfer of liability must be accompanied by a transfer of assets, it is important to note that this regulation says Code §414(l) will be satisfied ''if'' both assets and liabilities are transferred, as opposed to ''only if'' or ''will not be satisfied unless.'' The IRS has said that this regulation provides a safe harbor for transfers to satisfy Code §414(l) and is not the exclusive means of satisfying Code §414(l).[26] In the preambles to the regulations, the IRS acknowledged that liability-only transfers occur and did not highlight them as violating Code §414(l).

## Retiree Medical

One other use of excess assets in a pension plan is to provide medical benefits to retirees from that plan instead of from a separate retiree medical plan.

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[22] Treas. Reg. §1.414(l)-1(b)(5).

[23] Treas. Reg. §1.414(l)-1(e)(2), §1.414(l)-1(f).

[24] Treas. Reg. §1.414(l)-1(o).

[25] Treas. Reg. §1.414(l)-1(n).

[26] PLR 9422059 (Mar. 11, 1994).



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*401(h) Accounts*

IRS regulations provide that a qualified pension plan must primarily provide retirement income, and "a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan such as layoff benefits or benefits for sickness, accident, hospitalization, or medical expenses (except medical benefits described in section 401(h) as defined in paragraph (a) of §1.401-14)."[27] As described in Code §401(h), a plan may provide payment for medical expenses for retired employees, their spouses, and dependents as long as certain conditions are satisfied, including that "*such benefits are subordinate to the retirement benefits provided by the plan, a separate account is established and maintained for such benefits, and the employer's contributions to such accounts are reasonable and ascertainable. . . .*"[28] However, while adding 401(h) accounts to a plan would allow prospective contributions to fund medical benefits, Code §401(h) itself would not allow for using any excess assets already in the trust to fund medical benefits.

But Code §420 overcomes that obstacle, allowing a plan to use excess assets to fund 401(h) accounts. Under Code §420, excess assets can be transferred to health benefits accounts or life insurance accounts, and if certain requirements are met, the transfer is not included in the employer's gross income and is not treated as an employer reversion or a prohibited transaction.[29] Up to one transfer may be made per year, and the amount of the transfer may not exceed the amount reasonably expected to be paid from such accounts during that year. The health benefits must also satisfy certain cost requirements. In addition, all participants in the plan and those who separated from service during the one-year period ending on the date of the transfer must be fully vested. And most importantly, such transfers must be made no later than December 31, 2032.[30] In addition, notices to participants, the DOL, the IRS, the plan administrator, and employee organizations representing participants are due 60 days prior to the transfer.[31] Although, generally, plan assets must exceed 125% of the plan's funding target plus normal cost in order to transfer excess assets under Code §420, the SECURE 2.0 Act of 2022 now allows plans that have 110% excess assets to transfer up to 1.75% of the plan assets under the de minimis transfer rule.[32]

While Code §401(h) and §420 have several requirements, including some not mentioned above, those sections allow pension plan sponsors to use excess assets to provide medical benefits to retirees. Employers who are already providing such benefits outside of a pension plan may wish to investigate whether those benefits could be provided from an overfunded pension plan.

## Social Security Supplements (for Early Retirees)

If an employer with an overfunded pension plan wishes to provide retiree medical benefits from that plan rather than from a retiree medical plan, but does not want to deal with the recordkeeping and actuarial costs of dealing with 401(h) accounts and 420 transfers, it may consider offering a Social Security supplement to help with medical costs until the expected commencement of Social Security benefits.

A Social Security supplement commences upon early retirement and terminates when Social Security benefits can commence. The amount of the benefit may not exceed Social Security benefits.[33] A Social Security supplement is not part of the accrued benefit and can be reduced or eliminated.[34]

An employer providing retiree medical benefits could consider terminating the retiree medical plan and provide similar benefits under a pension plan as a Social Security supplement (provided it does not exceed the expected Social Security benefit). In order for this to work, the retiree receiving the retiree medical benefit must be a participant in the overfunded pension plan, and must commence an early retirement benefit under the pension plan in order to receive the Social Security supplement. In addition, there may be litigation risk associated with terminating a retiree medical plan. Regardless, this strategy may work for employers with the right retiree population.

## Severance or Voluntary Buy Out

Instead of funding any severance benefits through cash, an employer may consider providing retirement credits in lieu of severance benefits through an overfunded pension plan. An employer may provide the retirement credit in the form of contributions to a cash balance account within the plan. The plan could be amended to provide a one-time cash balance contribu-

[27] Treas. Reg. §1.401-1(b)(1)(i).

[28] Code §401(h) (emphasis supplied).

[29] Code §420(a)(3)(A).

[30] Code §420(b)(4).

[31] ERISA §101(e).

[32] Code §420(e)(7).

[33] Code §411(a)(9).

[34] Treas. Reg. §1.411(d)-4, Q&A-1(d).



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tion only to those who participate in a particular layoff. The employees can choose to leave the cash balance account in the plan (assuming they are otherwise allowed under the terms of the plan) or immediately receive the cash balance account as a taxable distribution or rollover into another tax-qualified vehicle. *Such retirement credits have substantial benefits over traditional severance, in addition to reducing cash costs: they escape FICA taxation for both the employer and the employee; can be structured to allow the employee to defer income taxation; and can be structured not to reduce state unemployment benefits*. Any benefit provided through the plan will need to comply with the limits of Code §401(a)(17) and §415. There would also be nondiscrimination issues to consider, although they could be minimized by providing the severance benefit through the qualified plan primarily for non-highly compensated employees. Also, the employee must be given the right to take that severance benefit in the form of a qualified joint and survivor annuity.

### Replace 401(k) Match With a Cash Balance Contribution

Instead of making matching or nonelective contributions to a 401(k) plan, an employer could contribute to a cash balance account in an overfunded pension plan. The employees may appreciate that they will get the cash balance contribution without necessarily having to make a deferral. They may also appreciate protections against investment and longevity risks that cash balance contributions in the pension plan may provide. There are some issues to consider in adopting this strategy. If there is not a complete overlap between the 401(k) plan and the pension plan, new participants will need to be added to the pension plan for whom PBGC premiums will need to be paid. Even if the 401(k) match is replaced with cash balance contributions, some matching or nonelective contributions in the 401(k) plan might still be needed to satisfy the actual deferral percentage (ADP) and actual contribution percentage (ACP) tests. Eliminating all matching and nonelective contributions will not be an option for a safe harbor 401(k) plan if the plan sponsor wishes to maintain the plan's safe harbor status. However, employers should consider the value they receive from safe harbor status by running an ADP test and seeing if the plan would pass anyway. This is especially true if the plan has automatic enrollment. It is extremely rare for plans with automatic enrollment to fail the ADP test.

## CONCLUSION

While overfunded pension plans present challenges in taking advantage of the excess assets, there are strategies (that don't involve termination and qualified replacement plans) that could work for some plan sponsors. Even if the above strategies don't work for an employer, one alternative always exists: unfreeze the plan and let participants accrue pension benefits.



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