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Issues Involving Overfunded Defined Benefit Plans

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Why Be Concerned?

- Interest rates have been at historic lows for many years and are expected to begin to increase
- The lump sum values of plan benefits will decrease with rising interest rates, dramatically increasing the number of overfunded plans and the amount of the overfunding.
- Owners, Employers and key employees need to know their options

Definition of Overfunded Plan

- Where plan assets exceed the present value of accrued benefits.
 - Computed on the termination basis
 - Using PBGC mandated assumptions to compute lump sums
 - Annuity purchase permitted where no lump sum option is available or when annuity is selected.
- Rollover and 414(k) accounts not treated as part of plan assets for this purpose



Who is Entitled to Overfunding?

- Plan participants or sponsoring employer – depends on language in plan document.
- Note: if participants are entitled to overfunding, plan amendment changing entitlement to employer cannot be effective for 5 years.
- Participants are entitlements limited by Section 415(b) of the Code, creating a practical issue for closely-held employers.



Reversion to Employer

- Reversion is subject a 50% non-deductible, non-offset-able excise tax.
- Revision constitutes taxable income to sponsoring employer
- Effective tax rate is 80% to 90%
- Example: Reversion of a million dollars
 - Excise tax is \$500,000
 - Income tax is as high as \$400,000, depending on employer's tax bracket and state and local taxes
- Approximately \$100,000 remains



Example of a Straight Reversion

	Straight Reversion	Straight Reversion
	C Corporation	S-Corporation/ LLC
Excess Available for Reversion	\$1,000,000	\$1,000,000
Spent on Benefits	-	
Company Level Transactions		
Gross Reversion	\$1,000,000	\$1,000,000
4980 Excise Tax (50% or 20% rates)	\$500,000	\$500,000
Ordinary Income Tax (40% assumed)	\$400,000	\$400,000
Net Reversion to Employer	\$100,000	\$100,000
Owner/ Shareholder Level Transactions		
Distributions to Shareholder(s)	\$100,000	\$100,000
Ordinary Income Tax (40% assumed)	\$40,000	\$0
Proceeds from Stock Sale	-	
Capital Gains Tax (20% assumed)	-	
Net After-Tax Recovery to Owners(s)	\$60,000	\$100,000
Deferred Tax Benefits		
Owner's Benefit Allocation (50%/25%)	-	
Deferred Tax (30% assumed effective)	-	
After-Tax Value of Deferred Benefits	-	
Total After-Tax Amount to Owner(s)	\$60,000	\$100,000
% of Excess Retained by Owner(s)	6%	10%

Alternatives to Reversion

- Amend plan to increase benefits to participants
- Add insurance or other ancillary benefits
- Allow overfunded plan to pass to next generation
- Rollover to defined contribution plan pursuant to Code Section 4980
- Possible to rollover to ESOP and use of funds to purchase employer stock
- Add post retiree welfare benefits to plan
- Engage in strategic sale of overfunded plan



Amend Plan to Increase benefits

- Amendment must be consistent with discrimination rules under 401(a)(4)
- If owners/key employees are at §415 limit, then only rank and file participants benefit from increase
- While additional accruals will benefit employees rather than the IRS, will not necessarily benefit owners/ key employees
- Sometimes benefits can be increased for family members.



Example of Benefit Increase

	25% Used to Increase Benefits C-Corp	25% Used To Increase Benefits S-Corp / LLC	50% Used to Increase Benefits C-Corp	50% Used to Increase Benefits S-Corp / LLC
Excess Available for Reversion	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Spent on Benefits	\$250,000	\$250,000	\$500,000	\$500,000
Company Level Transactions				
Gross Reversion	\$750,000	\$750,000	\$500,000	\$500,000
4980 Excise Tax (50% or 20% rates)	\$375,000	\$375,000	\$250,000	\$250,000
Ordinary Income Tax (40% assumed)	\$300,000	\$300,000	\$200,000	\$200,000
Net Reversion to Employer	\$75,000	\$75,000	\$50,000	\$50,000
Owner/ Shareholder Level Transactions				
Distributions to Shareholder(s)	\$75,000	\$75,000	\$50,000	\$50,000
Ordinary Income Tax (40% assumed)	\$30,000	\$0	\$20,000	\$0
Proceeds from Stock Sale	-	-	-	-
Capital Gains Tax (20% assumed)	-	-	-	-
Net After-Tax Recovery to Owners(s)	\$45,000	\$75,000	\$30,000	\$50,000
Deferred Tax Benefits				
Owner's Benefit Allocation (50%/25%)	\$125,000	\$125,000	\$250,000	\$250,000
Deferred Tax (30% assumed effective)	\$37,500	\$37,500	\$75,000	\$75,000
After-Tax Value of Deferred Benefits	\$87,500	\$87,500	\$175,000	\$175,000
Total After-Tax Amount to Owner(s)	\$132,500	\$162,500	\$205,000	\$225,000
% of Excess Retained by Owner(s)	13%	16%	21%	23%



Add Ancillary Benefits

- Life insurance is the primary benefit that will use up excess assets
- Purchases must be non-discriminatory and comply with incidental benefit rule
 - 100 times monthly benefit
 - Alternate 2/3 rule based up theoretical cost of monthly benefit at NRD
- Note requirements when purchasing insurance from the plan – PERC must be used
 - Query: Can CSV be used for valuation purposes



Transfer Business and Overfunding to Next Generation

- Most business valuations do not include the value of the overfunding
- Theoretically overfunding could disappear due to a change in interest rates, additional benefit accruals or investment losses
- For closely held businesses with few employees and where children intend to take over the business
- Overfunding can be transferred free of estate tax
- Risk: IRS will decide to challenge valuation on death of parents



Establish a Replacement Defined Contribution Plan

- Replacement Plan Requirements (§4980(d)(2))
 - Must cover 95% of the active participants in the overfunded plan who remain employees
 - Direct transfer of 25% of the amount of the reversion is made to the DC plan prior to the termination of the Plan
 - Funds are allocated to participants in the DC plan, subject to §415 limitations, within seven (7) years
- Excise tax on reversion is reduced to 20%



Is Asset Transfer Limited to 25%

- No. See Revenue Ruling 2003-85.
- The ruling involved a potential reversion of \$60x and a transfer to a DC replacement plan of 20x (or 33 1/3rd %).
- The IRS held that the DC plan was a qualified replacement plan under §4980(d) and that the amount transferred to the plan was not taxable and the remaining amount transferred to the employer was subject to a 20% excise tax



Examples – Replacement Plan

	25% Transferred To Replacement Plan	50% Transferred To Replacement Plan	75% Transferred To Replacement Plan	100% Transferred To Replacement Plan
Excess Available for Reversion	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Spent on Benefits	\$250,000	\$500,000	\$750,000	\$1,000,000
Company Level Transactions				
Gross Reversion	\$750,000	\$500,000	\$250,000	\$0
4980 Excise Tax (50% or 20% rates)	\$150,000	\$100,000	\$50,000	\$0
Ordinary Income Tax (40% assumed)	\$300,000	\$200,000	\$100,000	\$0
Net Reversion to Employer	\$300,000	\$200,000	\$100,000	\$0
Owner/ Shareholder Level Transactions				
Distributions to Shareholder(s)	\$300,000	\$200,000	\$100,000	\$0
Ordinary Income Tax (40% assumed)	\$120,000	\$80,000	\$40,000	\$0
Proceeds from Stock Sale	-			
Capital Gains Tax (20% assumed)	-			
Net After-Tax Recovery to Owners(s)	\$180,000	\$120,000	\$60,000	\$0
Deferred Tax Benefits				
Owner's Benefit Allocation (50%/25%)	\$62,500	\$125,000	\$187,500	\$250,000
Deferred Tax (30% assumed effective)	\$15,625	\$37,500	\$56,250	\$75,000
After-Tax Value of Deferred Benefits	\$46,875	\$87,500	\$131,250	\$175,000
Total After-Tax Amount to Owner(s)	\$226,875	\$207,500	\$191,250	\$175,000
% of Excess Retained by Owner(s)	23%	21%	19%	18%
Total After-Tax Amt to Owner(s) (Sub)	\$346,875	\$287,500	\$231,250	\$175,000
% of Excess Retained by Owner (Sub)	35%	29%	23%	18%

ESOP as a Replacement Plan

- Replacement plan can be an ESOP if it otherwise meets the requirements of a replacement plan.
- Advantage of an ESOP is that the funds can be paid directly to the owner of the business, as payment for the shares of the business.
- Funds paid to the owner by the ESOP are subject to capital gain treatment and may qualify for §1042 rollover treatment (allowing the owner to pay no tax on the funds received).
- Employees will receive allocation of shares in the ESOP and shares will be purchased by Employer upon termination of employment.



ESOP Alternative (Cont.)

- Problems with ESOP alternative:
 - Expensive transaction (must be treated as arms-length sale of business).
 - Need a desire to sell business.
 - Need a sufficient number of employees to allocate proceeds in 7 years
- Advantages:
 - In correct situation, owner of business can receive overfunding free of any tax under Code §1042



Transfer to Health Benefits Account

- §420 of the Code – Requirements:
 - Transfer to a health benefits account
 - One transfer per year
 - Not more than required for retiree health benefits for the year
 - Any amounts not used during the year are transferred back to the Plan and treated as a taxable reversion but are not taxable income to the employer
 - All plan benefits must be fully vested
 - Key employees excluded
 - Other complex and onerous rules



Transaction Involving Plan Sponsor

- Overfunding needed by sponsors of underfunded plans.
- Transactions involving sale of sponsors that take into account the value of overfunding in plan.
- PBGC likes transactions because they have the effect of reducing its insurance liability for failed plans.
- IRS has issued a ruling restricting transactions



Example of Transaction

	Strategic Stock Sale Alternative
Excess Available for Reversion	\$1,000,000
Spent on Benefits	-
Company Level Transactions	
Gross Reversion	-
4980 Excise Tax (50% or 20% rates)	-
Ordinary Income Tax (40% assumed)	-
Net Reversion to Employer	-
Owner/ Shareholder Level Transactions	
Distributions to Shareholder(s)	-
Ordinary Income Tax (40% assumed)	-
Proceeds from Stock Sale	\$700,000
Capital Gains Tax (20% assumed)	\$140,000
Net After-Tax Recovery to Owners(s)	\$560,000
Deferred Tax Benefits	
Owner's Benefit Allocation (50% assumed)	-
Deferred Tax (30% assumed effective rate)	-
After-Tax Value of Deferred Benefits	-
Total After-Tax Amount to Owner(s)	\$560,000
% of Excess Retained by Owner(s)	56%
Total After-Tax Amt to Owner(s) (Sub-S)	\$560,000
% of Excess Retained by Owner (Sub-S)	56%



Transaction Structure

- Current shareholders of plan sponsor create a second entity with a similar ownership structure.
- It is best for some business activity would be transferred to the entity. For example, it can be a service company to the plan sponsor, handling billing, collections, accounting etc. in exchange for a fee.
- The entity would adopt the Pension Plan as a second sponsoring employer.
- The stock of the entity would be sold to a third party willing to purchase an entity with an overfunded pension plan
- In addition to the value of the Company as an ongoing enterprise, the purchase price would be reflective of the value of the pension overfunding



Issues Associated with Transactions

- The purchase price would constitute long-term capital gains to the Sellers
- No excise tax will be due because no plan will be terminated and no reversion ever taken
- Argument that purchase price is an “indirect” reversion
- Argument that the plan is not maintained for the exclusive benefit of the employees



Revenue Ruling 2008-45

- Facts involve sale of an underfunded plan:
 - Plan and assets equal to amount of underfunding transferred to a wholly-owned subsidiary
 - Sub had no other business, no employees, and no other assets
 - Shortly thereafter Sub is sold to an unrelated 3rd party
- Holding: Exclusive benefit rule of §401(a) is violated if sponsorship of a qualified retirement plan is transferred to an unrelated taxpayer if the transfer is not in connection with a transfer of business assets, operations, or employees



Scope and Basis of IRS Position

- IRS position unaltered if some business assets, operations, or employees are transferred in the sale if “substantially all” of the business risks and opportunities are those associated with the plan
- Ruling based upon exclusive benefit rule – courts tend not to support IRS in disallowances based solely on the exclusive benefit rule.
- Prudent employers will justify purchase/sale with significant assets / business opportunities.



Alternate Structure – Joint Venture

- Partnership is formed 80% owned by owners of “overfunded” employer and 3rd party –engages in legitimate business activity.
- Partnership adopts Plan as co-sponsor.
- 3rd party loans 100% of overfunding to owners, secured by ownership of partnership interest and 35% loan reserve.
- Lender can only look to reserve and collateral for repayment.
- Loan defaults on the death of the owner and no gain results, because owner’s heirs receive step up in basis.
- Owner gets tax deduction for interest payments



Strategic Partnership Alternative

	Partnership Alternative
Excess Available for Reversion	\$1,000,000
Spent on Benefits	-
Company Level Transactions	
Gross Reversion	-
4980 Excise Tax (50% or 20% rates)	-
Ordinary Income Tax (40% assumed)	-
Net Reversion to Employer	-
Owner/ Shareholder Level Transactions	
Distributions to Shareholder(s)	-
Ordinary Income Tax (40% assumed)	-
Proceeds from Stock Sale	\$650,000
Capital Gains Tax (20% assumed)	\$0
Net After-Tax Recovery to Owners(s)	\$650,000
Deferred Tax Benefits	
Owner's Benefit Allocation (50%/25%)	\$350,000
Deferred Tax (30% assumed effective)	\$105,000
After-Tax Value of Deferred Benefits	-
Total After-Tax Amount to Owner(s)	\$755,000
% of Excess Retained by Owner(s)	76%
Total After-Tax Amt to Owner(s) (Sub)	\$755,000
% of Excess Retained by Owner (Sub)	76%



Conclusion

- Employers with defined benefit plans and their advisors should be aware of the possibility that those plans may become overfunded.
- Those with overfunded plans should be aware of their options to eliminate or otherwise deal with the overfunding in the most tax efficient manner
- Appropriate professional advice is the key to enabling employers and business owners to properly deal with overfunding situations



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