PART XIII: Defined Benefit Plans-Funding, Assumptions, and Benefits

Basic Funding Calculation

1301. How are the contributions to a defined benefit plan determined?

Prior to 2008, a defined benefit plan was funded with “level” contributions, i.e., all benefits were funded over future service, or by creating a past service liability based on benefits earned before the effective date of the plan and funding those benefits separately. The Pension Protection Act of 2006 (PPA) made extensive changes in the funding of defined benefit plans with the purpose of reducing the under-funding in many of those plans. The example below illustrates the concept of the new funding method although not the total method as provided in PPA.

*Example.* John’s retirement benefit at age sixty-five is $1,500 per month for life. He will earn this benefit proportionally over his working years. John’s current age is fifty. The annuity purchase rate is $137.52 required for each dollar of monthly benefit. Assume that the plan assets will earn 5 percent annually

Each year John earns a proportional amount of his future monthly benefit. Assuming there is no change in John’s salary his earned benefit (accrued benefit) at the end of the first year is $100 per month (or $1,500 per month divided by fifteen years).

The contribution for John in year one is equal to the present value of the reserve necessary to fund his accrued benefit of $100 per month as of the first day of the plan year:

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| --- |
| ($100 x $137.52) / (1.0515) = $6,615 |

Assuming no change in John’s salary year two, i.e. the first day of the second plan year is equal to:

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| --- |
| ($100 x $137.52) / (1.0514) = $6,946 |

1302. What is meant by “minimum funding standards?”

The *minimum funding standard* (also known as the *minimum contribution due*) is the sum of:[[1]](#footnote-1)

1. the target normal cost of the plan for the plan year;

2. the shortfall amortization charge (if any) for the plan for the plan year; and

3. the waiver amortization charge (if any) for the plan for the plan year.

Assuming the value of the plan assets is less than the funding target of the plan for the plan year (see Q 1304). Additional funding standards are listed below:

*Target normal cost:* Target normal cost means, for any plan year, the present value of all benefits that are expected to accrue or to be earned under the plan during the plan year.

*Shortfall amortization charge:* The shortfall amortization charge for a plan for any plan year is the aggregate total (not less than zero) of the shortfall amortization installments for such plan year with respect to the shortfall amortization bases for such plan year and each of the six preceding plan years.

*Shortfall amortization installment:* The shortfall amortization installments are the amounts necessary to amortize the shortfall amortization base of the plan for any plan year in level annual installments over the seven-plan-year period beginning with such plan year.

*Shortfall amortization base*: The shortfall amortization base of a plan for a plan year is the funding shortfall of such plan for such plan year, minus the present value of the aggregate total of the shortfall amortization installments and waiver amortization installments that have been determined for such plan year and any succeeding plan year with respect to the shortfall amortization bases and waiver amortization bases of the plan for any plan year preceding such plan year.

*Funding shortfall:* The funding shortfall of a plan for any plan year is the excess of the funding target of the plan for the plan year, over the value of plan assets for the plan year that are held by the plan on the valuation date.

*Waiver amortization charge:* The waiver amortization charge (if any) for a plan for any plan year is the aggregate total of the waiver amortization installments for such plan year with respect to the waiver amortization bases for each of the five preceding plan years.

*Waiver amortization installment:* The waiver amortization installments are the amounts necessary to amortize the waiver amortization base of the plan for any plan year in level annual installments over a period of five plan years beginning with the succeeding plan year.

*Waiver installment:* The waiver installment for any plan year in the five-year period is the annual installment determined under Code section 430(d)(2)(A) for that year for that base.

*Waiver amortization base:* The waiver amortization base of a plan for a plan year is the amount of the waived funding deficiency (if any) for such plan year under Code section 412(c).

1303. What is the purpose of quarterly funding contributions?

Code section 412(m) requires quarterly funding of defined benefit plans. A defined benefit plan is required to deposit, on a quarterly schedule, 25 percent of the lesser of 90 percent of the current plan year’s contribution or 100 percent of the prior year’s contribution. If the quarterly contribution is not made, the plan is charged interest on those contributions, which become part of the required contribution for the year.

Although in theory this is a step in the right direction to reduce underfunding, in practice it is not practical, particularly for small plans. Generally, the information necessary to calculate the current plan year contribution includes employee data and the value of plan assets. In most cases, the needed information is not forthcoming until well into the second quarter of the year following the end of the plan year and, in many cases, later than that. Because the first quarterly contribution is due April 15, it is almost impossible to meet this deadline and, in many cases, impossible to meet the next quarterly deadline of July 15.

As an alternative the plan can base the quarterly contributions on the prior year’s contribution and ignore the guideline that requires the plan to use the lesser of the two amounts. If that is done, the interest charge may be avoided, but it is then possible to make a nondeductible contribution subject to a 10 percent excise tax. This would occur if the quarterly contributions are based on the prior year’s contribution, yet when the current year’s contribution is determined, it is much lower than the prior year, and the quarterly contributions already made are in excess of 90 percent of the current year’s contribution. As a result of this dilemma, most small plans do not comply with the quarterly contribution requirement. Because there is no penalty, only interest charges, Code section 412(m) has little to no effect on small defined benefit plans.

1304. What is the role of the enrolled actuary in a defined benefit plan?

The calculations in a defined benefit plan are usually prepared or reviewed by an enrolled actuary. Most defined benefit plans file a Schedule SB with the Form 5500, Annual Returns/Reports of Employee Benefit Plan each year. The Schedule SB must be signed by an enrolled actuary confirming the funded status of the plan as of the date of the filing. The Joint Board for the Enrollment of Actuaries sets forth several standards of performance for enrolled actuaries including the following:

1. An enrolled actuary shall provide to the plan administrator upon appropriate request, supplemental advice or explanation relative to any report signed or certified by such enrolled actuary.

2. The enrolled actuary shall exercise due care, skill, prudence, and diligence to ensure that:

a. the actuarial assumptions are reasonable in the aggregate;

b. the actuarial cost method and the actuarial method of valuation of assets are appropriate;

c. the calculations are accurately carried out; and

d. the report, any recommendations to the plan administrator, and any supplemental advice or explanation relative to the report reflect the results of the calculations.

1305. What is the “funding target attainment percentage (AFTAP)”?

The funding target of a defined benefit plan is the sum of the present value of all accrued benefits at the beginning of the plan year.[[2]](#footnote-2) The “funding target attainment percentage” of a plan for a plan year is a ratio:

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| --- |
| *Value of plan assets for the plan year* |
| *Funding target of the plan for the plan year* |

If a defined benefit plan's assets are not equal to at least 80 percent of the plan's funding target, certain events are triggered automatically.[[3]](#footnote-3) If the percentage drops below 60 percent, even more "restrictions" kick in. Some of the events that can be triggered include a restriction on paying lump-sum distributions and a complete freeze of benefit accruals, which can happen without any action on the part of the employer. If an event is triggered, employees are required to be notified, generally before thirty days following the trigger date. The plan's actuary must certify the plan's AFTAP for each plan year.

1306. What other restrictions limit benefit payments?

To protect the benefits of rank-and-file employees in a plan that is not sufficiently funded, Treasury regulations restrict the ability of a plan to distribute lump sums to certain highly paid employees. The plan participants subject to this restriction are the twenty-five highly compensated employees (HCEs) with the highest compensation in the current year or any prior year.

The funding guidelines require plan assets to be at least 110 percent of its current liabilities,[[4]](#footnote-4) after the potentially restricted benefits are paid. If a plan cannot satisfy this requirement the benefit to the highly paid participant can only be distributed in the form of a single life annuity. As an alternative the plan can post security for the shortfall.[[5]](#footnote-5)

1307. How are benefits and accrued benefits determined?

*Example:*

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| --- |
| **Company and Plan Data** |
|  | PastService | Age | Compensation |
| Harold  | 24 yrs  | 60 | $265 ,000 |
| John  | 20 yrs | 55 | $100,000 |
|  |  |  |  |
| Nancy  | 3 yrs  | 42 | $ 25,000 |
| Max |  1 yr  | 38 | $ 35,000 |
| Louis  | 7 yrs  | 29 | $ 28,000 |
| Randy  | 6 yrs  | 25 |  $ 18,000 |
| Jesse  | 5 yrs  | 45 | $ 50,000 |
|  |  |  |  |

|  |  |
| --- | --- |
| Effective date of the plan:  | January 1, 2015  |
| Eligibility: | Age twenty-one and one year of service |
| Retirement age: | The later of age sixty-five or five years of planparticipation |
| Average compensation: | Highest three-year consecutive average |
| Retirement benefit formula: | 10 percent of average monthly compensation timestotal service up to ten years, service prior to January 1, 2010 , is excludedReformat the lines of text so the entire line is used, e.g. next to “Benefit accruals” the second line of text ends with the word “service” even though there is more space on the line |
| Normal retirement date: | Plan anniversary nearest retirement age |
| Normal form: | Life annuity |
| Benefit accruals: | 10 percent per year of service up to ten years, service before January 1, 2010 , is excluded  |
| Funding assumptions:  |  |
| Interest Rates: |  |
| Benefits due within 5 years | 1.98 percent |
| Benefits due between 6 and 20 years | 5.07 percent |
| Benefits due in more than 20 years | 6.19 percent |
| Mortality table: | 1971 Group Annuity Male @ 8.5 percent |

*T*he following is the result of the first plan valuation as of January 1, 2015 :



Monthly Benefit

Ten percent of average monthly compensation times total service up to ten years, service prior to January 1, 2010 is excluded. All calculations are done as of the first day of the plan year.

Benefit for Harold:

|  |  |
| --- | --- |
| Total service 01/01/1991 to 01/01/2015  | = 24 years |
| Total service to retirement 01/01/1991 to 01/01/2020  |  = 29 years |
| Monthly salary x 10% x total service (up to 10 years)  | = Benefit ($21,667 )  |
| (based on maximum for 2014 of $260 ,000) x 10% x 10  | = $21,667 per month |
| Maximum monthly benefit[[6]](#footnote-6) ($210 ,000 / 12)  | = $17,500  |
| Years of participation 01/01/2015 to 01/01/2020  | = 5 |
| Years of participation for maximum benefit[[7]](#footnote-7) | = 10 |
| Monthly benefit ($17,500 x 5 / 10)  | = $8,750  |

The benefit limit for 2015 is the lesser of 100 percent of the high three-year average compensation of the employee or the dollar limit of $210 ,000 annually. The maximum benefit is actuarially reduced if paid in any form other than life only, e.g., life and ten years certain, or if paid prior to age sixty-two.[[8]](#footnote-8) If benefits are paid after age sixty-five the maximum is actuarially increased.[[9]](#footnote-9)

Accrued Benefit for Harold:

|  |  |
| --- | --- |
| Total credited service 01/01/2010 to 01/01/2015  | = 5 years |
| Total credited service to retirement 01/01/2010 to 01/01/2020  | = 10 years |
| Monthly benefit ($17,500 x 5 / 10)  | = $8,750  |
| $8,750 x 5 / 10  | = $4,375  |
| Maximum accrued benefit:[[10]](#footnote-10) |  |
| Dollar limit on benefit x 10% ($210 ,000 / 12) x 10% | = $1,750  |

Even though as of January 1, 2015 , Harold has no participation (because January 1, 2015 , is the effective date of the plan), he still may take credit for one year, i.e., a 10 percent accrual maximum.[[11]](#footnote-11)

Accrued Benefit for Max :

|  |  |
| --- | --- |
| Total credited service 01/01/2011 to 01/01/2015  | = 4 years |
| Total credited service to retirement 01/01/2011 to 01/01/2042  | = 31 years |
| Monthly benefit ($2,917 x 4 / 10  | = $1,166.67  |

Since the accrued benefit is not more than the maximum accrued benefit [($210 ,000 / 12) x 10% = $1,750 ], the resulting accrued benefit is $1,166.67 rounded to $1,167.

The following is the result of the second plan valuation as of January 1, 2016 /:

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1308. Can a plan be amended to reduce retirement benefits?

Amending the plan to a lower benefit, after funding the plan at a higher benefit for several plan years, would have the effect of reducing the contribution. When amending the plan the result cannot reduce the monthly benefit below the accrued benefit already earned. Any plan amendment must be done before the end of the plan year, and if the participant has worked 1,000 hours or more, the accrued benefit as of the end of the plan year must be based on the benefit before it was reduced by the amendment. If the amendment is executed and effective early in the plan year, before the participants work 1,000 hours, it would affect the accrued benefit for that year but could not reduce the prior accrued benefit. In addition, all participants must be notified of the reduction in future benefit accruals at least fifteen days before the effective date of that reduction.[[12]](#footnote-12)

It is also possible to freeze all future benefit accruals. That would be equivalent to the retirement benefit being amended to the current accrued benefit. The same rules apply for notice to participants as if the plan were amended. Freezing benefit accruals has the effect of eliminating the entire target normal cost (see Q 1302), assuming salaries do not increase for the plan year, limiting the minimum contribution to the seven-year amortization of the funding shortfall (the funding target less the plan assets).

1309. What is a funding waiver?

In cases of financial stress the plan sponsor may apply to the Internal Revenue Service (IRS) for a funding waiver. To be eligible for such a waiver, the plan sponsor must show that satisfying the funding requirement would create a temporary business hardship and would be adverse to the best interests of the plan participants.[[13]](#footnote-13) The IRS will consider the following in determining whether a business hardship exists:[[14]](#footnote-14)

1. if the employer is operating at a loss;

2. if there is substantial unemployment or underemployment in the trade or business and the industry;

3. if the sales and profits of the industry are depressed or declining; and

4. if it is reasonable to expect that the plan will be continued only if the waiver is granted.

 If the funding waiver is granted, the waived contribution must be amortized over no more than five years and no more than three waivers will be granted in a fifteen-year period.

Other Government Organizations Relating to Defined Benefit Plans

1310. What is the Pension Benefit Guaranty Corporation (PBGC)?

Because defined benefit plans promise a retirement benefit that depends on the solvency and funding level of the plan, there is always a possibility that the plan sponsor may not be able to fund the plan because of financial difficulty or, worse yet, insolvency or bankruptcy. In 1974 the Employee Retirement Income Security Act of 1974 (ERISA) established the Pension Benefit Guaranty Corporation (PBGC), a government-owned corporation that is responsible for overseeing terminations of defined benefit plans and insuring benefits under those plans.

Benefits payable with respect to a plan participant can be guaranteed only to the extent that they do not exceed the actuarial value of a monthly benefit in the form of a life annuity starting at age sixty-five equal to the lesser of:

1. one-twelfth of the participant’s average annual “gross income” from his or her employer during either:

a. the highest-paid five consecutive calendar years in which he or she was an active plan participant; or

b. if he or she was not an active participant throughout that period, the number of calendar years within that period in which he or she was active; or

2. $750 multiplied by a fraction:

a. whose denominator is $13,200; and

b. whose numerator is the Social Security contribution and benefit base in effect at the time the plan terminates.

For the year 2014 the PBGC guarantees monthly benefits up to $5,011.36 . This amount is adjusted annually as indicated in item 2 above. Defined benefit plans subject to PBGC rules must pay an annual premium of $57 per participant plus a variable premium of $24 for each $1,000 of unfunded vested benefits. The variable portion has no limit. Exempt are defined benefit plans that cover only owners or professional service employers, e.g., medical practitioners that do not have more than twenty-five participants.

1311. What is Financial Accounting Standards Board (FASB), Statement No. 158?

The purpose and focus of FASB 158 is to standardize financial reporting for defined benefit pension plans and, in some cases, defined contribution pension plans. The accounting community and those that relied on the financial statements of the companies sponsoring retirement plans felt that the reporting of pension costs were not consistent from one company to another and, in some cases, not consistent from period to period in the same company. In addition pension liabilities and assets were not properly recognized on financial statements. The financial community felt that pension costs for a specific period were not necessarily reflected by the contribution made by the sponsoring employer but should also take into consideration other factors including tax considerations, availability of cash to fund the plan, and alternate investments available, all of which should be based on accrual accounting.

The fundamentals of pension accounting, according to FASB, include delaying recognition of certain events, reporting net cost, and offsetting liabilities against assets. Delayed recognition means that changes in the pension liabilities and changes in the assets earmarked to fund those liabilities should not be recognized as they occur but over future periods. Net cost means that transactions affecting a pension plan should be reported as a single net amount on the employer’s financial statement rather than separate items. Lastly, offsetting reflects the value of assets in the plan and the liabilities recognized for past periods as a net pension cost on the employer’s financial statement. Toward these ends FASB 158 requires a standardized method for measuring net periodic pension cost and immediate recognition of a liability on the company’s financial statement when the accumulated liability exceeds the fair market value of plan assets or reporting of gain when the assets exceed the accumulated liability.

Because the measurement of pension costs for accounting purposes focuses more on the current period than on future periods the assumptions used in the FASB calculations are more consistent with current financial conditions. The interest assumption used to discount benefits is based on the rate at which the pension benefits can be funded currently rather than a rate that is reasonable in the aggregate with other assumptions.

The same concept is applied in determining the rate of return on plan assets. In that case the rate of return on current plan assets must be considered as well as the rate of return that may be available on reinvested assets. Another difference in assumptions between the funding of a defined benefit plan and the reporting of pension costs for FASB is in the basis for compensation. In most small to medium-sized plans benefits are based on the high three- to five-year average of actual compensation history. FASB requires that compensation levels be projected, usually by applying a salary scale if benefits are based on final average pay or career average pay.

Guidelines for preparing a FASB report are a good deal more complex than this limited summary. The conclusion is that reporting for pension costs for accounting purposes is entirely different than reporting pension costs for actuarial funding purposes.

1312. What is the process for terminating a defined benefit plan?

The complexity of the termination process is dependent on whether the plan sponsor files with the IRS for an approval letter and the type of plan being terminated—a defined contribution plan or a defined benefit plan. If the sponsor applies to the IRS, the determination letter received confirms that the plan termination will not adversely affect the qualified status of the plan, i.e., the plan sponsor and the employee participants will not lose any of the tax benefits.

In a defined benefit plan, because the plan is promising retirement benefits that may or may not be fully funded, the procedure is much more complex than for a defined contribution plan in which each participant has an account balance representing the actual assets in the plan. Also, in some cases, defined benefit plans have excess assets that may revert to the employer when the plan is terminated. The rules under ERISA, the Internal Revenue Code (Code), and Treasury regulations for terminating defined benefit plans protect participants from plan terminations designed to allow the plan sponsor to recapture those excess assets.

In all cases, when a qualified retirement plan is terminated, the plan must be amended to meet the qualification requirements that are in effect at the time of termination.[[15]](#footnote-15) Termination amendments must be adopted by the termination date. Ongoing plans have until the end of the remedial amendment period to make the necessary amendments. In addition, when a plan is terminated, all participants become 100 percent vested in their accrued benefits regardless of their service credits for vesting. Plans not subject to minimum funding standards, including profit sharing and stock bonus plans, are also required to provide 100 percent vesting in the case of a complete discontinuance of contributions.[[16]](#footnote-16)

Accrued benefits (see Q 1307) are defined as the benefit earned as of a specific date under a defined benefit plan. Partial terminations (discussed at Q 1313) are also required to provide 100 percent vesting with respect to the terminating employees.[[17]](#footnote-17)

One of the requirements for a retirement plan to be qualified is that it is intended to be permanent. If the IRS determines that a plan was not intended to be permanent because it terminates within a few years of adoption, the plan can be disqualified retroactively.[[18]](#footnote-18) The determination of permanence is based on the facts and circumstances involved. A plan terminated because of a business necessity, e.g., ongoing losses caused by a business depression, would still be considered to have the intent of being permanent at the time it was adopted. Furthermore, a plan must satisfy the vesting (discussed previously) and nondiscrimination rules on termination. Failure to satisfy these rules could result in plan disqualification, causing disallowance of employer deductions for prior contributions, and assessment of taxes on plan investment earnings.

1313. What is a partial plan termination?

A partial termination was considered something less than a plan termination. Unfortunately, a partial plan termination is based on the ever-present facts and circumstances. In some cases, a partial termination occurs when a group of employees is excluded from coverage through plan amendment, e.g., a class (specific job or geographical location) of employees is excluded from coverage that was not excluded before. In some cases, the discharge of a significant number of employees or a significant percentage of the total work force could be considered a partial termination.[[19]](#footnote-19) In a partial termination, 100 percent vesting is required only for the employees affected by the partial termination.

Courts have taken the position in some cases that a partial termination has occurred if a “significant percentage” of employees have been excluded from coverage. One court ruled that a partial termination had occurred when ninety-five out of 165 participants (57.6 percent) were discharged because one division of the employer was dissolved, regardless of whether the discharge was caused by adverse economic conditions.[[20]](#footnote-20)

In another case, twelve out of fifteen employees who refused to transfer to the employer’s new business location were discharged, causing the plan to have a partial termination.[[21]](#footnote-21) Other cases have indicated that 34 percent, 51 percent, 70.6 percent, and 80 percent were considered significant percentages.[[22]](#footnote-22)

In one case, the exclusion of 15 percent of the participants did not constitute a partial termination, and the same court noted that 34 percent was the lowest percent that would be considered significant.[[23]](#footnote-23)

Generally if the turnover rate is at least 20 percent it is presumed that a partial termination has occurred.[[24]](#footnote-24) That rate is determined by dividing the number of participating employees that had an employer-directed severance by the sum of all participating employees. Employer-initiated severance includes any severance other than death, disability, or retirement on or after normal retirement age as provided in the plan. If the employer can provide documentation that supports a position that the severance was voluntary on the part of the employee then it is not presumed to be an employer-initiated severance. In some cases even if the turnover rate is at least 20 percent the facts and circumstances may show that a partial termination has not occurred. If, for example, a turnover rate in excess of 20 percent is common in the specific industry, e.g. fast-food establishments, then a partial termination has not occurred.

When an employee leaves voluntarily, absent a significant corporate event causing that voluntary termination, a partial termination is not triggered. To further confuse matters, the courts differ on which employees are to be considered when calculating the number or percentage of terminated employees. On remand from the US Supreme Court, the US Court of Appeals for the Seventh Circuit held that only nonvested plan participants can be counted in determining whether a partial termination has occurred.[[25]](#footnote-25) Yet the original determination by the Seventh Circuit held that both vested and nonvested participants should be counted.

1314. Who has the authority to terminate a defined benefit plan?

Defined benefit plans can be terminated voluntarily by the plan sponsor or involuntarily by the PBGC, a nonprofit corporation that insures participants and beneficiaries against the loss of benefits. The form of voluntary termination depends on whether the plan is properly funded. If the assets are sufficient to fund the accrued benefits, the plan can be terminated in a standard termination by the plan sponsor. If the assets are insufficient, a distress termination by the PBGC is the only alternative but it is available only if:

1. the employer is in a liquidation proceeding under bankruptcy law;

2. the employer is in a reorganization proceeding under bankruptcy law;

3. the employer proves to the PBGC that plan termination is necessary to pay debts or to avoid burdensome costs; or

4. the plan sponsor cannot continue in business unless the plan is terminated.

1315. What is an underfunded defined benefit plan?

The value of each participant’s benefit as of the beginning of a plan year is the present value of the accrued benefit. If the assets are less than the present value of the accrued benefit the employer can choose to terminate this plan but only in a distress termination. To be eligible for a standard termination, the employer would have to make up the difference between the present value of the accrued benefits and the actual plan assets.

Before filing a standard termination notice with the PBGC, the employer can make a commitment to contribute any additional amount necessary to fund all liabilities.[[26]](#footnote-26) This commitment must be made to the plan in writing and signed by the employer. As an alternative, an individual who owns 50 percent or more of the plan sponsor may waive receipt of all or a portion of his or her benefits until the assets are sufficient to fund the plan liabilities.[[27]](#footnote-27) The election must be in writing and the owner’s spouse must consent since the plan requires spousal consent for distributions in a form other than a joint and survivor annuity. The contribution necessary to fund the remaining liabilities may not be totally deductible in the year it is contributed but may have to be amortized over up to ten years. Contributions necessary to fund benefits guaranteed by the PBGC in accordance with Code section 4022 are fully deductible.

1316. What is an overfunded defined benefit plan?

It is also possible that a defined benefit plan could be overfunded. In that case, the assets are in excess of the present value of accrued benefits. In a standard termination, the assets could exceed the benefits due the participants because of above-average investment performance or accelerated funding. The excess assets must be allocated in a nondiscriminatory manner or revert back to the employer. If the assets are to be reallocated to the participants, the method used would be to amend the plan so the present value of the amended accrued benefits is equal to the total plan assets.[[28]](#footnote-28) The resulting increase in the present value of each participant’s accrued benefit must be nondiscriminatory, e.g., the increase in value for each participant is the same percent of the benefit’s original value.

The other alternative for the disposition of excess assets is to return the assets to the plan sponsor. Generally, the excess assets that are returned to the plan sponsor are subject to a 50 percent excise tax in addition to income taxes at the plan sponsor’s level. If the employer establishes a *qualified replacement plan* or increases the benefits in the defined benefit plan, the excise tax is reduced to 20 percent.[[29]](#footnote-29)

A qualified replacement plan is a qualified plan established or maintained by the employer in connection with a qualified plan termination that meets the following requirements:

1. At least 95 percent of the active participants in the terminated plan who remain employees of the employer after the termination are active participants in the replacement plan.

2. At least 25 percent of the excess assets must be transferred to the replacement plan.

3. If the replacement plan is a defined contribution plan, the amounts must be allocated to the participants in the year transferred or held in a suspense account and credited to the participants over no more than seven years.

This two-level excise tax rate structure has several purposes. First, it is designed to recapture the tax benefits to the employer of tax-deferred earnings during the life of the plan that are not being used to provide benefits to the participants. Second, it is intended to encourage the plan sponsor either to maintain a qualified plan after terminating the defined benefit plan or to provide benefit increases before terminating the plan.

If a qualified replacement plan terminates before the suspense account has been allocated to participants, the suspense account must be allocated to participants as of the termination date. If a portion of the suspense account referred to in item 3 above cannot be allocated to any participants when the qualified replacement plan terminates, the portion remaining is treated as a reversion to the employer, is included in the employer’s gross income, and is subject to the 50 percent excise tax on reversions.[[30]](#footnote-30) This may occur if all the participants are at their Code section 415 limit, i.e., the lesser of 100 percent of compensation or $53 ,000 (for 2015 ).

In one case, 100 percent of the excess assets from a terminated defined benefit plan was transferred to a qualified replacement plan; only the minimum 25 percent of the surplus required to be transferred to qualify for the 20 percent excise tax rate was exempt from the excise tax. The remaining 75 percent of the excess assets was subject to the 20 percent excise tax, although none of the excess assets transferred to the qualified replacement plan were included in the taxable income of the employer sponsoring the plan.[[31]](#footnote-31)

1317. What procedures must be followed in a “standard termination”?

To begin a voluntary standard termination, a *notice of intent to terminate* must be given to *affected parties* at least sixty days, but no more than ninety days, before the termination date set forth in the notice.[[32]](#footnote-32) The sixty-day time limit will not be extended by the PBGC. If it is missed, the termination date has to be changed, which could require additional plan contributions if additional benefits were earned between the original termination date and the new termination date.

The term *affected parties* means, with respect to a plan:[[33]](#footnote-33)

1. each participant in the plan;

2. each beneficiary under the plan who is a beneficiary of a deceased participant or who is an alternate payee under an applicable qualified domestic relations order;

3. each employee organization representing participants in the plan; and

4. the PBGC, except that, in connection with any notice required to be provided to the affected party, if an affected party has designated, in writing, a person to receive such notice on behalf of the affected party, any reference to the affected party shall be construed to refer to such person.

The *notice of intent to terminate* must include the following information:

1. the name and plan number of the plan;

2. the name and employer identification number of each contributing employer;

3. the name, address, and telephone number of the person to contact by an affected party with questions concerning the termination;

4. a statement that the plan administrator intends to terminate the plan in a standard termination by a specific date and that the affected party will be notified if the date is changed or the termination does not occur;

5. a statement that plan assets must be sufficient to terminate the plan in a standard termination;

6. a statement, if applicable, that:

a. benefit accruals will stop on the termination date but continue if the plan is not terminated,

b. a plan amendment has been adopted terminating benefit accruals in accordance with ERISA section 204(h) as of the termination date or some other date regardless of whether the plan is terminated, and

c. benefit accruals terminated as of some date before the notice of intent to terminate was issued;

7. a statement that each affected party entitled to benefits will receive written notification regarding the plan benefits;

8. a statement explaining how an affected party can obtain the most recent summary plan description;

9. a statement to participants receiving monthly benefits, if applicable, informing them that their monthly benefits will not be affected by the termination or explaining how their benefits will be affected; and

10. a statement that the PBGC will not guarantee a participant’s or beneficiary’s benefits after plan assets have been distributed in satisfaction of those benefits.

1318. What steps must the plan sponsor take after providing the notice of intent to terminate?

If the plan sponsor is a corporation, a corporate resolution should be adopted by the board of directors to terminate the plan. If the plan sponsor is not incorporated, a company resolution should be prepared and signed by the sole proprietor or partners. The resolution should also state that all future benefit accruals will be discontinued. If legislation has been passed since the last time the plan document was prepared or restated, an amendment must be adopted to bring the plan into compliance with the current qualification rules. The plan sponsor must then determine whether the termination will be submitted to the IRS for approval. Although this is a voluntary filing, if approved, it does assure the employer and the employees that the termination will not adversely affect the qualified status of the plan and all plan benefits will retain their tax-favored status. If the plan is submitted to the IRS for a determination letter on plan termination, the participants and beneficiaries of the plan must be notified.

After the notice of intent to terminate is provided to participants, the plan administrator files a standard termination notice with the PBGC no later than 180 days after the proposed termination date as set forth in the notice of intent to terminate. This is done on PBGC Form 500, Standard Termination Notice, Single Employer Plan Termination with Schedule EA-S, and Standard Termination Certification of Sufficiency.[[34]](#footnote-34) The Schedule EA-S must be certified by an enrolled actuary that the assets are sufficient to pay all benefits.

The ERISA plan administrator (usually the plan sponsor) must provide a notice of plan benefits to the participants and beneficiaries no later than the day on which the standard termination notice is filed with the PBGC.[[35]](#footnote-35) The notice of plan benefits must include:[[36]](#footnote-36)

1. the name of the plan;

2. the name and employer identification number of the contributing sponsors;

3. the plan number;

4. the name, address, and telephone number of the person to contact to answer questions regarding the participant’s or beneficiary’s benefits;

5. the proposed termination date;

6. a statement that the amount of the plan benefits is an estimate and that benefits actually paid may be more or less than the estimate; and

7. the data on which benefits have been based, to the extent applicable, including:[[37]](#footnote-37)

a. the participant’s age at retirement,

b. the participant’s spouse’s age,

c. the participant’s length of service, and

d. the participant’s actual or estimated Social Security benefit and, if estimated, the earnings history used for the estimate.

1319. What action will the PBGC take after the termination is submitted?

The PBGC has sixty days to issue a notice of noncompliance if it determines that assets are not sufficient to pay all benefits or if the procedural requirements for the termination are not followed. A notice of noncompliance nullifies the termination proceedings and returns the plan to active status, i.e., an ongoing plan.

If a notice of noncompliance is not issued, the plan assets must be distributed by the later of 180 days after the end of the PBGC sixty-day review period or 120 days after receipt of a favorable determination letter from the IRS if the termination was filed with the IRS.[[38]](#footnote-38) To take advantage of the later date, the IRS submission must be made by the time the standard termination notice was filed with the PBGC. Within thirty days after the assets are distributed, the plan administrator must file on PBGC Form 501, Post-Distribution Certification for Standard Terminations, that the participants have received all of their benefits.[[39]](#footnote-39)

1320. What is a distress termination?

For a defined benefit plan to file voluntarily as a distress termination, the PBGC must determine that one of the following requirements has been met:[[40]](#footnote-40)

* The plan sponsor has filed for a liquidation in bankruptcy;
* The plan sponsor has filed for reorganization;
* The plan sponsor cannot continue in business; or
* The costs to continue the plan would be unreasonably burdensome.

Before terminating the plan in a distress termination, the plan administrator must:

* Provide a notice of intent to terminate to each affected party at least sixty days and no more than ninety days before the proposed termination date;
* File a distress termination notice with the PBGC on PBGC Form 601, Distress Termination Notice Single Employer Plan Termination, including a Schedule EA-D, Distress Termination Enrolled Actuary Certification, no later than 120 days after the proposed termination date; and
* Confirm that the PBGC has determined that the plan sponsor has satisfied at least one of the four preceding requirements.

While distress termination proceedings are pending, the plan administrator must continue to carry out normal plan operation, including putting participants into pay status, collecting contributions due the plan, investing plan assets, paying monthly benefits attributable to employer contributions, and continuing to pay all benefit liabilities; however, starting on the proposed termination date, benefits must be reduced to the level provided in PBGC regulations.[[41]](#footnote-41)

During the termination the plan administrator is subject to the following restrictions:[[42]](#footnote-42)

1. He or she may not make loans to plan participants, beginning on the first day the plan administrator issues a notice of intent to terminate.

2. Beginning on the first day the plan administrator issues a notice of intent to terminate until a distribution is permitted in closing out the plan, he or she may not:

a. Distribute plan assets or take other action to help bring about the termination of the plan;

b. Pay benefits attributable to employer contributions (other than death benefits) in any form other than as an annuity; or

c. Buy irrevocable commitments to provide benefits from an insurer.

Although the employer may qualify for a distress termination, that does not prevent the PBGC from pursuing the employer to recapture assets.

1321. What is an involuntary termination?

In addition to the voluntary termination procedures, the PBGC may initiate an involuntary termination in the appropriate U.S. District Court if:

* The loss to the PBGC will increase unreasonably if the plan is not terminated;
* The plan has not met the minimum funding standards (see Q 1302);
* The plan is deficient in paying the tax for failure to meet the minimum funding standards;
* The plan will not be able to pay benefits when due; or
* A distribution is made to a substantial owner of $10,000 or more, for a reason other than death, such that after the distribution the vested benefits of the other participants are not totally funded.

If the plan is terminated under PBGC involuntary proceedings, the employees can recover benefits in excess of those provided under the PBGC insurance from the employer.[[43]](#footnote-43) After proceedings are initiated by the PBGC, an application will be made to the appropriate US district court to appoint a trustee to administer the plan pending the issuance of a court decree to terminate the plan. In some cases, the PBGC may be appointed as trustee. After the trustee is appointed, a notice regarding the termination must be given to interested parties, including:

1. the plan administrator;

2. participants and beneficiaries;

3. the employer;

4. employers in multiemployer plans who may be subject to withdrawal liability;

5. employers who have an obligation to contribute under a multiemployer plan; and

6. employee organizations that represent plan participants of employers in preceding items 3, 4, and 5.

When a plan is terminated in a distress termination or involuntarily by the PBGC, the employer is liable to the PBGC for the total amount of the unfunded benefit liabilities of all participants and beneficiaries plus interest.[[44]](#footnote-44) Generally, this amount is due to the PBGC as of the termination date. In some cases, the PBGC will arrange for special payment terms. If the PBGC determines that the liability exceeds 30 percent of the collective net worth of the entity subject to the liability, the PBGC will prescribe reasonable terms for payment of the portion of the liability that exceeds 30 percent of the collective net worth of the entity liable. The terms prescribed by the PBGC for payment of that portion of the liability (including interest) will provide for deferral of 50 percent of any amount otherwise payable for any year if the entity subject to the liability demonstrates to the satisfaction of the PBGC that the entity does not have any pre-tax profits for the last full fiscal year ending during that year.[[45]](#footnote-45)

1. . IRC Sec. 430. [↑](#footnote-ref-1)
2. . IRC Sec. 430(d)(2). This concept of present value is illustrated in Q 1301. [↑](#footnote-ref-2)
3. . IRC Sec. 436. [↑](#footnote-ref-3)
4. . IRC Sec. 412(l)(7). [↑](#footnote-ref-4)
5. . Rev. Rul. 92-76, 1992-2 CB. 76. [↑](#footnote-ref-5)
6. . IRC Sec. 415(b)(1). [↑](#footnote-ref-6)
7. . IRC Sec. 415(b)(5)(A). [↑](#footnote-ref-7)
8. . IRC Sec. 415(b)(2)(B), IRC Sec. 415(b)(2)(C). [↑](#footnote-ref-8)
9. . IRC Sec. 415(b)(2)(D). [↑](#footnote-ref-9)
10. . IRC Sec. 415(b)(5)(A). [↑](#footnote-ref-10)
11. . Treas. Reg. §1.415(b)-1(g)1(i)(A). [↑](#footnote-ref-11)
12. . ERISA Sec. 204(h). [↑](#footnote-ref-12)
13. . IRC Sec. 412(d)(1). [↑](#footnote-ref-13)
14. . IRC Sec. 412(d)(2). [↑](#footnote-ref-14)
15. . Notice 87-57; Announcement 94-101; IRC Sec. 521(3). [↑](#footnote-ref-15)
16. . IRC Sec. 411(d)(3); Treas. Reg. §1.411(d)-2; Rev. Rul. 73-450, 1973-2 C.B. 140 [↑](#footnote-ref-16)
17. . Treas. Reg. §§1.401-6(a); 1.411(d)-2(a)(1). [↑](#footnote-ref-17)
18. . Treas. Reg. §1.401-1(b)(2). [↑](#footnote-ref-18)
19. . Treas. Reg. §1.401-6(b)(2). [↑](#footnote-ref-19)
20. . Rev. Rul. 81-27. [↑](#footnote-ref-20)
21. . Rev. Rul. 73-284. [↑](#footnote-ref-21)
22. . Rev. Rul. 72-439, Rev. Rul. 72-510, Rev. Rul. 73-284. [↑](#footnote-ref-22)
23. . *Kreis vs. Charles O. Townley, M.D. & Associates*, 6th Cir. 1987. [↑](#footnote-ref-23)
24. . Rev. Rul. 2007-43. [↑](#footnote-ref-24)
25. . *Robert Matz v. Household International Tax Reduction Investment Plan*, 265 F.3d 572 (7th Cir. 2001). [↑](#footnote-ref-25)
26. . PBGC Reg. §4041.21(b)(1). [↑](#footnote-ref-26)
27. . PBGC Reg. §4041.21(b)(2). [↑](#footnote-ref-27)
28. . Rev. Rul. 80-229. [↑](#footnote-ref-28)
29. . IRC Sec. 4980(a), Sec. 4980(d). [↑](#footnote-ref-29)
30. . IRC Sec. 4980(d)(2)(C)(iv). [↑](#footnote-ref-30)
31. . Ltr. Ruls. 9823051. 9839031. [↑](#footnote-ref-31)
32. . ERISA Sec. 4041(a)(2); PBGC Reg. §4041.23(a). [↑](#footnote-ref-32)
33. . ERISA Sec. 4001(a)(21). [↑](#footnote-ref-33)
34. . PBGC Reg. §4041.25. [↑](#footnote-ref-34)
35. . PBGC Reg. §4041.24(a). [↑](#footnote-ref-35)
36. . PBGC Reg. §4041.24(b). [↑](#footnote-ref-36)
37. . PBGC Reg. §4041.24(b)(4). [↑](#footnote-ref-37)
38. . PBGC Reg. §4041.28(a)(1). [↑](#footnote-ref-38)
39. . PBGC Reg. §4041.29(a). [↑](#footnote-ref-39)
40. . PBGC Reg. §4041.41(c). [↑](#footnote-ref-40)
41. . PBGC Reg. §4022.61. [↑](#footnote-ref-41)
42. . PBGC Reg. §4041.47(b)(1). [↑](#footnote-ref-42)
43. . *Murphy v. Heppenstall Co*., 635 F.2d 233 (3rd Cir. 1980). [↑](#footnote-ref-43)
44. . ERISA Sec. 4062(a); ERISA Sec. 4062(b)(1)(A); PBGC Reg. §4062.3(a). [↑](#footnote-ref-44)
45. . PBGC Reg. §4062.8(c). [↑](#footnote-ref-45)