

Publications

Surplus Plan Assets Continue to Puzzle IRS and Frustrate Plan Sponsors

ATTORNEYS & PROFESSIONALS

Kathryn Bjornstad Amin

kamin@groom.com

202-861-2604

Elizabeth Drake

edrake@groom.com

202-861-6322

Christine Keller

ckeller@groom.com

202-861-9371

Louis T. Mazawey

lmazawey@groom.com

202-861-6608

Brigen Winters

bwinters@groom.com

202-861-6618

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Over the years, many plan sponsors have accumulated surplus assets in their pension and welfare benefit programs for various reasons. Typically, surplus assets have been generated in these mature programs through some combination of strong investment performance, plan design changes, fluctuating coverage and participant demographics, etc. The affected overfunded benefit arrangements include (in no particular order):

1. voluntary employees' beneficiary associations (Code sec. 501(c)(9)) funding retiree medical benefits,
2. retiree medical accounts held in Code section 401(h) subaccounts under qualified defined benefit plans, and
3. defined benefit plans that include legacy components from other plans, have been frozen, and/or experienced strong investment performance.

In private letter rulings, plan sponsors have sought IRS approval of transactions that allow the use of the surplus to avoid the 100% excise tax (Code sec. 4976) or 50% excise tax (Code sec. 4980) on reversions from VEBAs and qualified plans, respectively. Regrettably, IRS decided to stop ruling on VEBA transactions pending further study in 2020 (Rev. Proc. 2022-3, sec. 3.01(133)). Code section 401(h) by its terms limits the use of its funds to retiree medical benefits – and it is unclear what happens to such accounts when the defined benefit plans of which they are a part terminate.

On June 21, the IRS announced another “no rule” position – this time to apparently discourage the use of pension plan surplus in transactions that may otherwise be permitted under Code section 4980(d)(2). That section allows surplus pension assets to be transferred to fund nonelective contributions in a defined contribution plan without income or excise taxes if certain requirements are met (Rev. Rul. 2003-85). In this regard, a plan sponsor with an overfunded plan might, for example, wish to spin-off and terminate the portion of the plan attributable to certain participants, and use the surplus to fund future defined contribution plan benefits. However, recent Rev. Proc. 2022-28 states that, pending further study, IRS will not rule on a transaction where –

- less than 100% of the assets of a defined benefit plan are spun-off to any defined benefit plan within the same controlled group,
- the defined benefit plan receiving the spun-off assets is terminated “within a short period of time” after receiving those assets, and
- there are remaining assets in the trust of the terminated plan after all benefits are paid out.

Some open questions here that may be worth exploring include –

- If the spun-off plan is not within the controlled group, will the IRS consider a ruling? Under Code section 414(l)(2)(D)(ii) plans transferred outside of the controlled group are not subject to the pro rata allocation of surplus rules.
- It may be possible to terminate the spun-off plan and get a ruling after “a short period of time” after receiving the assets has elapsed. Generally, the spin-off would need to involve a pro-rata allocation of assets under Code section 414(l) because the spun-off plan stays in the same controlled group. But a “short period of time” is not defined.

Observations

IRS “no-ruling” positions do not mean that a transaction is not permitted, only that the IRS will not opine in advance of the transaction. However, the plan, and plan sponsor, bear the risk that if the IRS takes a contrary position, the transaction could result in plan disqualification and surplus assets being treated as reversions that trigger onerous excise taxes.

Plan sponsors are often reluctant to proceed with significant transactions until the IRS provides guidance, but they may have to wait quite a while. Once an issue is added to the “no rule” list, it can stay there for many years. In the meantime, surplus plan assets continue to accumulate tax-free, exacerbating the issues associated with surplus plan assets, and plan sponsors are left with few alternatives, including to efficiently use the surplus plan assets to provide benefit improvements to employees.

Groom has extensive experience advising plan sponsors with overfunded benefit plans with respect to use of surplus assets, and is engaged in policy efforts to facilitate the use of these assets to provide valuable employee benefits. Please contact the authors, [Katie Bjornstad Amin](#), [Elizabeth Drake](#), [Christine Keller](#), [Louis Mazawey](#), [Brigen Winters](#), [Jeff Witt](#) or or any of our Groom attorneys if one or both initiatives are of interest.

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