Bloomberg Tax

Tax Management
Compensation Planning Journal™

De-Risking Pitfalls – Annuity Contracts, Plan Terminations and the Excise Tax on Surplus Assets

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INTRODUCTION

The costs of sponsoring a defined benefit pension plan are often associated with financial risk, and the transfer or management of such risk, known as ''de-risking,'' has become more common. Financial risk via the continued sponsorship of a defined benefit pension plan comes in many forms: the increased life expectancy of plan participants; the uncertainty associated with investment rates of return; prospective changes in interest rates; and changes in a plan's funded status. De-risking can address these financial risks through either ''in-plan'' (e.g., investment management) or ''out-of-plan'' (e.g., lump-sum window) strategies. A common out-of-plan strategy is to de-risk by purchasing an annuity contract from an insurance company, which shifts financial risk from the plan sponsor to the annuity provider.

Typically, the purchase of an annuity contract by a plan sponsor will coincide with the termination of the plan and, unless the plan is well funded, the sponsor will be required to contribute additional funds to the plan to fund the purchase of the annuity. Various factors – the timing between the funding of the annuity purchase and the purchase itself (e.g., a change in interest rates), the quality of plan data (e.g., awareness of missing or deceased participants), or the discovery of additional liabilities or plan assets – can influence the annuity contract purchase price. To the extent assets remain in a plan following the purchase of an annuity, recovering those amounts can be costly – and may not even be possible – unless the sponsor can show the amounts were contributed due to an erroneous actuarial computation or mistake of fact. The remainder of this article discusses the law and Internal Revenue Service guidance related to reversions and practical considerations.

THE CODE, TREASURY REGULATIONS, AND ERISA

The Code's Exclusive Benefit Rule

Generally, §401(a)(2) prohibits the diversion of plan assets for purposes other than the exclusive benefit of employees or beneficiaries prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust.[1] Reg. §1.401-2(b)(1) clarifies that the intent and purpose of the phrase ''prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust'' is to permit the employer to reserve the right to recover, at plan termination, any balance remaining in the trust that is due to erroneous actuarial computations. Specifically, Reg. §1.401-2(b)(1) provides that a balance due to an ''erroneous actuarial computation'' means the surplus between actual funding requirements and expected funding requirements, even though expected funding requirements were (1) based upon actuarial valuations of liabilities or determinations of costs of providing benefits under the plan and (2) such valuations or determinations were made by a person competent to make such determinations (in accordance with reasonable assumptions as to mortality, interest, and proper procedures relating to the method of funding).

As an example, Reg. §1.401-2(b)(1) supposes that a trust has accumulated assets of $1 million at the time of liquidation, determined by acceptable methods as being necessary to provide the benefits in accor-

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John is grateful for the guidance and comments that Lou Mazawey, a principal in Groom Law Group, provided in the preparation of this article.

[1] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

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dance with the provisions of the plan. Upon the trust's liquidation, it is found that $950,000 will satisfy all of the liabilities under the plan. Therefore, the surplus of $50,000 arises because of a difference between actual and expected funding requirements required to satisfy plan liabilities and, accordingly, may be returned to the employer as the result of an erroneous actuarial computation. If, however, the surplus of $50,000 had been accumulated as a result of an amendment that changes the benefit provisions or the eligibility requirements of the plan, the $50,000 could not revert to the employer because such surplus would not be the result of an erroneous actuarial computation.

ERISA

Section 403(c)(2)(A) of the Employee Retirement Income Security Act of 1974, as amended, provides that a contribution or payment that is made by an employer to a plan (other than a multiemployer plan) by a mistake of fact may be returned to the employer within one year after the payment of the contribution. Under Rev. Rul. 91-4, a plan must contain a specific provision authorizing the return of employer contributions based on a mistake of fact.

ERISA §1344(d)(2) also contains an authorization requirement, providing that any amendment providing for a distribution to an employer of residual assets in a plan following termination (discussed in more detail under ''Private Letter Rulings'' below) shall not be treated as effective until the end of the fifth calendar year following the date of the adoption of such amendment.

Excise Tax on Reversion

Code §4980 imposes an excise tax on the amount of any direct or indirect ''employer reversion'' from a ''qualified plan.'' Section 4980(c)(2)(A) defines ''employer reversion'' as the amount of cash and the fair market value of other property received directly or indirectly by an employer from the qualified plan. Section 4980(c)(1) defines the term ''qualified plan'' as any plan (other than a governmental plan or a plan maintained by an employer exempt from federal income tax – e.g., a section 501(c) organization) that has been determined at any time to be qualified under §401(a). Generally, the excise tax under §4980 is 50% of the amount of the employer reversion. However, under §4980(d), this excise tax rate is reduced to 20% if (1) 25% of the amount of the reversion is transferred to a ''qualified replacement plan'' or (2) 25% of the reversion is applied to provide enhanced benefits under the terminating plan. There are also special exceptions for amounts transferred to ESOPs.[2]

Section 4980(c)(2)(B)(ii)(II) provides that an ''employer reversion'' does not include an amount distributed to an employer based on mistake of fact.

PRIVATE LETTER RULINGS

A taxpayer may seek a private letter ruling (PLR) from the IRS when the taxpayer wishes to have the Code (and applicable Treasury regulations) applied to a specific set of facts. A PLR may be sought for many reasons, including: (1) the law is unclear as to how it applies to a fact pattern, (2) an insurance company, trustee, or other similar entity may require the issuance of a PLR prior to engaging in a transaction, or (3) a taxpayer wants certainty as to the tax implications of a given action. As of February 1, 2019, the user fee to request a PLR is $30,000.

The IRS has issued at least three favorable PLRs relating to reversion and mistake of fact. A PLR only applies to the taxpayer that requested it, and §6110(k)(3) provides that a PLR may not be used or cited by others as precedent. However, PLRs do provide helpful insight into the IRS's views on issues. Please note that each plan discussed below contained provisions permitting (1) a return of employer contributions within one year made under a mistake of fact and (2) the return of amounts held in the trust in excess of plan liabilities following termination.

PLR 201228055

In PLR 201228055, Company A sponsored a single-employer defined benefit plan (DB Plan). Company A sold the majority of its assets to Company B, an unrelated company. Company A discontinued the operation of its business, and most of its employees became employees of Company B. Company B, in connection with the purchase of Company A's assets, changed its name to Company C and then merged with the entity requesting the PLR (Taxpayer). Following the purchase of assets from Company A, Company B (now the Taxpayer) fully funded and terminated the DB Plan.

After receiving a bid, the Taxpayer purchased a single-premium group annuity contract to cover all of the DB Plan's liabilities on termination. The amount of the single premium was calculated by the insurer based upon census data provided in the bid specification and internal actuarial assumptions on mortality and estimated rates of return. The assets held in the DB Plan were not sufficient to pay the cost of the single premium, so additional amounts were contributed to the DB Plan to cover that cost. The insurer subsequently discovered certain errors in the participant census data that generated a premium refund into the DB Plan (the Amount). The single-premium group annuity contract covered all of the liabilities of the DB Plan and the sole asset remaining in the DB Plan's trust was the Amount (plus earnings).

The IRS ruled that the Amount existed because of a mistake of fact, but arose because of two contributions made by Taxpayer, each of which was more than one year prior to the date of the PLR. Therefore, the Amount could not be returned under ERISA §403(c)(2)(A). However, the IRS also ruled that the Amount was the result of an ''erroneous actuarial computation,'' as described in Reg.§1.401-2, and therefore could be returned to Taxpayer subsequent to the satisfaction of all liabilities in accordance with the regulation and the DB Plan language, such that the return of Amount was not considered an employer reversion triggering an excise tax.

[2] *See* §4980(c)(3).

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PLR 201424032

In PLR 201424032, a company (Sponsor) purchased certain assets and assumed certain liabilities from a prior company, an unrelated entity. In connection with this transaction, the assets and liabilities of the prior company's qualified plan were transferred to the Sponsor's single-employer defined benefit pension plan (DB Plan). The Sponsor then terminated the DB Plan and made two contributions to ensure there were sufficient assets to effect a standard termination. However, the Sponsor inadvertently failed to include a money market account in its analysis, and therefore the DB Plan had surplus assets. After all the benefit liabilities in the Plan were satisfied, a certain amount (Amount) remained in the DB Plan trust.

The IRS found that the Company used an incorrect asset value in calculating the contribution to the DB Plan, which in turn caused the Plan to have surplus assets after all liabilities were satisfied. Based on this, the IRS ruled that such mistake constituted a ''mistake of fact'' as contemplated by ERISA §403(c)(2)(A) and Code §4980(c)(2)(B)(ii)(II) and, as such, the return of Amount to the Sponsor did not constitute an employer reversion triggering an excise tax.

PLR 201839010

In PLR 201839010, a company (Sponsor) sponsored and maintained a single-employer tax qualified defined benefit plan (Plan) for its employees. In 2017, the Sponsor terminated the Plan and, to fully fund the Plan's estimated liabilities upon termination, the Sponsor contributed an amount to cover the unfunded cost of a group annuity contract (Contract) for the Plan participants and beneficiaries. However, after the Contract was purchased, it was determined that the Plan had overpaid because a number of annuitants covered by the Contract were no longer living. The amount of this overpayment Excess Amount) was returned to the Plan.

The IRS found that, due to the liabilities associated with previously deceased participants, the Company used an incorrect asset value in calculating the contribution to the DB Plan, which in turn caused the Plan to have surplus assets after all liabilities were satisfied. Accordingly, the IRS ruled that such mistake constituted a ''mistake of fact'' as contemplated by ERISA §403(c)(2)(A) and resulted in an ''erroneous actuarial calculation'' under Reg.§1.401-2(b)(1). As such, the return of Excess Amount to the Sponsor did not constitute an employer reversion under Code §401(a)(2) or §4980(c)(2)(B) triggering an excise tax.

PLANNING CONSIDERATIONS

When purchasing an annuity to fund plan liabilities in connection with a termination, a plan sponsor should be cognizant of factors influencing the annuity purchase price that may result in surprises later. Plan sponsors should make sure the following occurs:

- The purchase of the annuity should occur within a reasonable period of time following funding to minimize price fluctuations that may result in excess plan assets,
- Plan data should be reviewed closely to assure missing and deceased participants and beneficiaries (including alternate payees) are identified so that the annuity price is properly estimated, and
- Plan assets should be reviewed so that additional contributions to a plan to fund an annuity are minimized.

To the extent excess assets remain in a plan following an annuity purchase, a sponsor has several options:

- **Reduced Excise Tax.** The excise tax rate is reduced to 20% if (1) 25% of the amount of the reversion is transferred to a ''qualified replacement plan'' or (2) 25% of the reversion is applied to provide enhanced benefits under the terminating plan. A sponsor should consider whether either of these options would be viable. A reduced excise tax may also be an option to the extent the sponsor maintains, and makes a transfer to, an ESOP.
- **PLR.** Based on its facts and circumstances, a sponsor could request its own PLR. To the extent an excess amount remains in a plan due to an ''erroneous actuarial computation'' or ''mistake of fact,'' the IRS may issue a PLR like those described above, though there is risk that the IRS could come to a different conclusion. Of course, the plan would need to provide for the return of excess assets and should be reviewed accordingly (keeping in mind the five-year rule under ERISA §1344(d)(2)). Additionally, an excess amount contributed due to a mistake of fact must be returned within one year, so funding and purchasing the annuity should be done in a timely manner. To the extent an excess amount is identified outside of the one-year time frame, it may still have been contributed due to an erroneous actuarial computation. Both legal concepts are applied based on the facts and circumstances.
- **Reporting.** The statute of limitations on the excise tax can be started by filing a Form 5330. Specifically, a sponsor could file a Form 5330 with the IRS noting an excise tax of $0 (line 14) on an excess amount. The excise tax of $0 is calculated using Schedule I of the Form 5330 (line 3 of Schedule I is the amount reported on line 14) and any explanation of why there is no excise tax may be included at line 4 of Schedule I. Of course, this approach should only be used to the extent a sponsor reasonably believes the facts and circumstances support that a returned amount is not subject to an excise tax on reversion.

ISSN 0747-8607

When dealing with excess assets in a terminated plan, the above options should be carefully considered. The advice of counsel generally should be sought, as the excise tax on reversions is just one of many potentially costly considerations in de-risking pension benefits.

ISSN 0747-8607