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Using a qualified replacement plan to reduce excise tax on DB plan surplus

By Brian J. Kearney and Margaret Berger
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In this article

With interest rates rising, some employers might be considering terminating their defined benefit (DB) plans to take advantage of reduced plan termination liabilities. However, these sponsors may run the risk of creating trapped surplus, which could result in a reversion subject to a steep excise tax. One potential solution that may reduce or avoid the excise tax is to transfer any DB surplus assets to a qualified replacement plan (QRP). (Another solution is to give participants a pro rata benefit increase in the DB plan at termination, but this article doesn't discuss that option.) Although a QRP can be either a defined contribution (DC) or DB plan, this article focuses on the DC plan option.

QRP option explained

Under Internal Revenue Code Section 4980, employers pay a 50% excise tax (in addition to regular income tax) on reversions from terminated DB plans. (Tax-exempt employers are generally not subject to either tax.) However, if the terminated DB plan transfers at least 25% of its surplus to a QRP, the employer pays no excise on the transferred amounts and a reduced 20% excise tax on amounts received as a reversion. The employer avoids the excise tax entirely if 100% of the surplus is transferred to the QRP. No matter the percentage transferred, the transfer must be made directly from the terminated DB plan to the QRP; surplus routed through the employer is subject to the excise tax. Because employer contributions to a DB plan are deductible when paid to the plan, the employer gets no tax deduction for amounts transferred to the QRP.

Employer has flexibility to designate QRP. A QRP can be a new or existing plan or even multiple plans. As noted above, a QRP can be a DB or a DC plan — including a 401(k) plan, subject to certain restrictions on how the surplus can be used (see below). A QRP must be established and maintained in connection with the termination of a DB plan, but IRS has issued little guidance on what exactly that means. IRS private letter rulings (PLRs) indicate a QRP doesn't have to be a new plan. Presumably, the employer only needs to designate the receiving plan (whether new or existing) as a QRP for the surplus.

PLRs. IRS may issue a PLR on several aspects of these transactions — for example, whether the receiving plan is a QRP or the transaction results in a reversion to the sponsor. But these PLRs are optional; employers considering the QRP option can do so without getting an IRS ruling.

"Spin/terms." IRS has signaled that it does not look favorably on the QRP option in combination with a spinoff transaction. The agency recently announced that it will not issue a PLR on whether a reversion has occurred when a DB plan terminates within "a short period of time" after being spun off from another DB plan sponsored by the same employer. (Nothing in the announcement suggests IRS would be more receptive to ruling on a transaction in which the original plan terminates after the spinoff.) Employers considering the QRP option in combination with a spinoff/termination may feel comfortable pursuing the strategy without a PLR. However, these employers might want to consult legal counsel. As discussed below, even a termination occurring a longer period of time after a spinoff could invite IRS scrutiny.

QRP and DB plan coverage overlap

The QRP must benefit at least 95% of the "active participants" in the terminating DB plan who remain employed in the employer's controlled group, but the QRP can also benefit other employees.

No definition of active participant. The rules don't say who's an active participant for this purpose. Active employees who were earning benefits under the DB plan clearly count. But an employee apparently doesn't have to be accruing benefits under the DB plan to be considered an active participant. In PLRs (for example, PLR 200344025), IRS has counted employees with frozen benefits under a terminating DB plan as active participants when determining if the QRP satisfies the 95% requirement, even though they had ceased accruing benefits.

> *Example — frozen plan*. Employer X sponsors DB plan A, which provides no new accruals. Employer X terminates A and transfers the surplus assets to plan B, a DC plan intended to serve as a QRP. Plan A has 1,000 participants with frozen benefits who are still employed by X. Under the IRS position taken in some PLRs, at least 950 of these participants must benefit under plan B to satisfy the 95% requirement.

> *Example — closed plan*. Employer Y sponsors DB plan C, which closed to new entrants in 2014. Plan C has 300 employees still accruing benefits and 700 who are no longer accruing benefits (for a total of 1,000 participants). Employer Y terminates C and transfers the surplus assets to plan D, a DC plan. Plan D will be a QRP if it covers at least 950 of the employees with benefits under plan C.

Terminating DB plan has no active-employee participants. The rules do not specifically address how the 95% requirement works when none of the terminating DB plan's participants is actively employed within the controlled group. Consider the following example.

> *Example — "old and cold" plan*. Employer Z sponsors plan E, a DB plan. All of plan E's participants are either retirees in pay status or terminated vested participants. Employer Z terminates plan E and

transfers the surplus assets to plan F, a DC plan. None of the retirees or terminated vested participants from plan E benefit under plan F.

A literal reading of the statute would suggest that no participants of terminating plan E would have to be covered by the QRP (because 95% of zero is zero). However, some people have raised concerns about this interpretation. IRS seems unlikely to challenge this transaction because it presents little potential for abuse. But IRS might find other situations objectionable.

Example — spinoff and subsequent termination. Employer Q sponsors DB plan J. Q spins off plan J's benefits and liabilities for active employees to new DB plan K. After the spinoff, only retirees and terminated vested participants remain in plan J. Q later terminates plan J and transfers the surplus assets to a DC plan that doesn't cover any of the active participants in K.

Here, IRS might view the spinoff to plan K and the termination of plan J as a single transaction and count the active participants in plan K in determining whether the 95% requirement is satisfied. If so, the transaction would fail to meet that requirement since none of the participants in plan K benefit under the replacement DC plan. IRS, the Pension Benefit Guaranty Corp. and the Labor Department took a similar approach to spinoff-termination transactions in the 1984 Joint Implementation Guidelines on Asset Reversions in Plan Terminations. Under those guidelines, if an employer recovers surplus from a spunoff plan, the remaining ongoing plan has to meet the plan termination requirements (such as full vesting and annuitization). Employers considering this type of transaction should consult with counsel.

No limit on other employees participating in QRP. Although the QRP must benefit at least 95% of active participants in the terminating DB plan, no limits restrict how many other employees — such as employees hired after the plan freeze or asset transfer — can participate in the QRP or benefit from the transferred surplus.

Example. Employer Z sponsors DB plan F and DC plan G. Plan F has 500 active participants, and G has 1,500 active participants. All of F's active participants are also participants under G. Employer Z terminates F and transfers all of F's surplus to G. The 95% requirement is satisfied in this case because 100% of F's active participants are participants under G. This is the case even though G has another 1,000 participants who never benefitted under F but will share in the surplus. If 200 individuals join plan G a year after the surplus transfer, they too could benefit from the surplus. Any new employees hired after the transaction could also benefit from the surplus.

25% minimum transfer

In general, an employer must transfer at least 25% — and can transfer up to 100% — of the surplus to the QRP. Rev. Rul. 2003-85 provides that the employer pays no excise tax on any surplus transferred to a QRP, including amounts exceeding 25%.

The value of any benefit increases provided when terminating a DB plan can reduce the minimum transfer below 25% of the surplus. For example, if an employer adopts an amendment increasing benefits and the present value of the benefit increase is 10% of the surplus, then the 25% minimum is reduced to 15%. This reduction applies only if the sponsor adopts the amendment within 60 days of — and the benefit increase takes effect on — the DB plan's termination date.

Allocating transferred surplus

The surplus must be allocated to participants' accounts at least as rapidly as ratably over a period up to seven years, beginning with the year of the transfer. PLRs (for example, PLR 200836035) have approved the following allocation schedule as meeting this requirement:

- 1/7 of the transferred surplus in the year of the transfer
- 1/6 of the remaining surplus in the second year
- 1/5 of the remaining surplus in the third year
- 1/4 of the remaining surplus in the fourth year
- 1/3 of the remaining surplus in the fifth year
- 1/2 of the remaining surplus in the sixth year
- Remaining balance in the seventh year

This schedule essentially allocates 1/7 of the initial amount each year, adjusted for earnings. However, the rules don't specify how to make the allocation, so IRS might allow other reasonable methods. The employer can allocate the surplus more quickly — for example, by allocating larger amounts earlier in the schedule or over fewer than seven years — but not more slowly.

Unallocated surplus held in suspense account. Any unallocated surplus during the allocation period must be held in a suspense account. The suspense account is a plan asset, so plan fiduciaries will need to handle investment of the surplus until it's allocated to participants' accounts. Income earned on the surplus must be allocated at least as rapidly as ratably over the remaining allocation period.

Strict adherence to seven-year schedule required. The entire transferred surplus generally must be allocated within the seven-year period. Although the rules aren't clear, failure to do so may result in disqualification of the QRP. (However, IRS has recognized exceptions when Section 415 limits have prevented allocation of the full amount of transferred surplus.) Given these allocation requirements, employers need to be careful when determining the amount of surplus assets to transfer to a QRP. For example, if the workforce shrinks, the allocation rules may force the employer to provide higher contributions to employees than intended, as is illustrated in the following example.

> *Example*. Employer X maintains a pension plan and a DC plan that cover all of X's employees. The DC plan includes an annual nonelective contribution equal to 3% of each employee's pay. The employer estimates that the annual cost of the 3% contribution is $5 million. X terminates the pension plan in 2022 and transfers $35 million in surplus assets to the DC plan. Using a seven-year allocation schedule, X expects to allocate $5 million each year and fully pay for the 3% nonelective contribution.

In 2023, X lays off 20% of its workforce, reducing the cost of the 3% nonelective contribution to $4 million. However, to satisfy the seven-year ratable allocation requirement, the DC plan must allocate at least $5 million each year, resulting in a nonelective contribution that is closer to 3.75% of pay.

Restrictions on using surplus

Although sponsors have a great deal of flexibility on how they can use the transferred surplus, the rules include some limitations.

Can't fund matching contributions. A number of PLRs say that surplus assets transferred to a QRP can't be used to fund matching contributions earned after the transfer. This is because the transferred surplus is treated as a contribution, and Section 401(m) regulations prohibit employers from funding matching contributions before an employee's elective deferrals have been made or before the employee has performed the services to which the contributions relate. In most cases, surplus assets are transferred to a QRP before participants have earned a match, so the surplus can't be used for matching contributions.

Exception for match earned prior to transfer. The employer may have a one-time opportunity to use the surplus to fund matching contributions in the year of the transfer if it occurs on or after the time the employees earn the match for that year. A good example is a transfer to a QRP that requires participants to be employed on the last day of the plan year to receive the match. A transfer made on the last day of the QRP's plan year will occur simultaneously with — instead of prior to — employees earning the match. In this case, the employer should be able to use the surplus to fund matching contributions for the plan year in which the transfer occurs — but only that plan year — without violating the prohibition on prefunding matching contributions.

Can fund nonelective contributions. Although transferred surplus generally can't be used for matching contributions, it can fund employer nonelective contributions, including contributions not yet earned. Employers that currently make only matching contributions may want to consider amending their plans to add nonelective contributions that can be paid using the surplus from the terminated DB plan. For example, an employer may want to shift a portion of the match into a nonelective contribution at the same benefit level.

Employers also can use the transferred surplus to provide a nonelective contribution in a safe harbor 401(k) plan. If the plan relies on a safe harbor nonelective contribution, the employer can use the transferred surplus to fund that contribution. Alternatively, an employer could switch from a safe harbor match to a safe harbor nonelective contribution (consistent with the timing rules for design changes to safe harbor 401(k) plans) funded with the surplus. Or the employer could retain the safe harbor match and fund an additional employer contribution with the surplus.

Can pay for administrative expenses. Several PLRs (for example, PLR 201147032) say employers can use surplus assets to pay reasonable administrative expenses of the QRP. This apparently is the case for expenses in the year of the surplus transfer and later years (as long as the surplus is used up within seven years).

Implementation issues

Sponsors considering the QRP option should be aware of the necessary plan documentation, participant communications and other administrative tasks.

Plan amendments. Both the transferring DB plan and the recipient DC plan may need amendments to enable the transfer. For example, the employer may have to create a suspense account in the DC plan and add procedures for allocating amounts from the suspense account to participants' accounts. Some preapproved DC plan documents may not have sufficient flexibility to accommodate these changes. In that case, the employer may need to switch to another preapproved plan or an individually designed plan (which may not be able to obtain a determination letter, due to IRS's curtailment of that program).

SMM or updated SPD. Participants must receive a summary of material modifications (SMM) or an updated summary plan description (SPD) communicating the changes.

Coordination with service providers. Employers considering the QRP option should discuss the concept well in advance with the recipient DC plan's service providers. Some providers may not be able to administer a suspense account or may require a new service agreement, additional fees, and start-up time to handle the transfer.

Related resources

Non-Mercer resources

- Rev. Proc. 2022-28 (IRS, June 17, 2022)
- PLR 201147032 (IRS, Aug. 1, 2010)
- PLR 200836035 (IRS, June 11, 2008)
- Rev. Rul. 2003-85 (IRS, Aug. 11, 2003)
- PLR 200344025 (IRS, Aug. 6, 2003)

Mercer Law & Policy resource

- IRS stops ruling on DB plan spin-term reversions (June 23, 2022)

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