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Managing Pension Surplus (or the Lack Thereof)

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Summary: Attendees learn some techniques for managing defined-benefit pension plans surplus assets and some tax-advantaged (and not-so-tax-advantaged) ways of tapping that surplus, if the plan sponsor so desires.

However, based on recent market losses and interest-rate decreases, some plan sponsors who have comfortably relied on an asset surplus to control contribution requirements and the Financial Accounting Standard 87 pension cost have seen that surplus shrink or disappear altogether. The attendees learn some techniques for minimizing and controlling the damage caused by market forces.

Mr. Douglas L. Thompson: Although most certainly we will be talking about how to make use of surplus assets in pension plans, as opposed to managing the lack thereof, I think these days there's a little more surplus than there is lack thereof.

Just a little bit of background with respect to the topic. I think, obviously, everybody's aware of the funded status of the pension plan for which you are the actuary given recent improvements and the investment markets over the last several years. There are a whole lot of plans sitting out there with surplus assets. For many of these plans there are no contributions required to keep the plan funded and possibly no contributions permitted that would be tax-deductible. As a result of the economic pressures that our clients are under in general, there's a lot of interest on their part in making use of the surplus assets that are sitting in the pension plan.

What are the reasons that companies want to get hold of these assets? In my experience there are really three reasons. This is a little bit like real estate. The first reason is they want access to cash (for an immediate need). That might take the form of immediate cash to make use of for nonpension plan purposes.
The second reason is a reduction in their annual cash expenditures because they may have some cash-flow requirements right now that are causing them problems. They would like to be able to make use of their annual cash flow for those other purposes.

The third reason is an avoidance of future increases in cash expenditures. They may have something coming up that has a cash-flow requirement that they would like to avoid and, again, make use of the assets in the pension plan for that purpose.

It’s really cash in the experience that I've had. In *Financial Accounting Standard (FAS) 87* accounting, you're already making pretty good use of the surplus asset as it is anyway because you can get credit for it even to the point of generating net income. But in funding you can't take contributions out of the plan on an annual basis.

Of course, there are other implications besides the cash. For some companies the financial accounting implications of what happened to that surplus may be the same if they're more interested in the cash. I believe that's going to be an important issue.

The tax implications are very important. In fact, there can be very ominous tax implications for the company, depending upon how they actually make use of the surplus. And, depending upon the technique that's being applied, the impact on employee taxes can be a very important issue. Also, depending on how employees are being affected, the human resources impact of what you're doing can be very important.

What I think is becoming a more important issue is the image that the company has in the community. Some of the things we're going to be talking about could be perceived as rather draconian. Certainly lots of things about pension-plan surplus are viewed by *The Wall Street Journal* as being draconian. There were two articles in *The Wall Street Journal* by Ellen Schultz. One of them talked about how, on an ongoing basis, companies actually get credit in the financial accounting for surpluses generating income. The article spoke of that in a very negative tone. She went on to talk about how companies are actually getting access to the surplus via termination of the plan using some of the techniques we're going to be talking about. She was quite critical of companies going from a 50% excise tax to a 20% excise tax as somehow bending the rules. These two articles are really a follow-up on the previous articles that have been written about cash-balance plans and how companies are being very active in cash-balance plans and making use of the assets in the pension plan in a different way. The community certainly includes the media, which is paying a lot more attention to how companies are making use of the assets in the pension plan.

Before we look at some of the specific strategies for making use of the surplus assets, I wanted to give at least some attention to managing the lack of surplus not so much from the standpoint of dealing with plans that are severely underfunded, but, considering how difficult it is to get money out of a pension plan, thinking on an ongoing basis what the policies are of our clients in putting money into the plan in the first place. I think, probably, the most fundamental question is, Is putting money into the pension plan good use of the company's resources? Is getting the tax deduction and tax deferral of investing in the markets as a whole a better use of their assets than investing in the business and generating taxable income?

The answer to that should be no for, hopefully, all of our clients. The answer should be no, because that's not good use of the money in and of its own right. What goes into the pension plan from the plan sponsor's standpoint would probably be only the necessary contributions to keep the plan properly funded, because those assets are hard to get at. You have to go through hoops to get the money out or you pay onerous taxes. Certainly, we fund and do the accounting for the pension plans of our clients on an ongoing basis, but ongoing isn't forever. Change in business is certainly the way of the present and will be the way of the future; I don't think any one of our clients could say for certain what they are going to look like as an entity five years from now. And there are lots of things that can happen to the company that could cause the funded benefits of the pension plan to become a significant financial issue from an immediate standpoint.

For example, when entering into a financial transaction that draws a lot of attention to this plan if you get to that point where accessing that money becomes important and you've created a big surplus, then you've created a problem. Therefore, I think it's important for us to rethink a bit what the policies are for contributions going into the pension plans on an ongoing basis. I think we tend to be conservative. We certainly have tended in the past to be pretty conservative with our assumptions when you look at what kind of terms are available in the investment market in general. That's part of the reason, actually, why we have some of the surpluses that we have today. Maybe we've been more conservative than we needed to be. Certainly what drives contributions today is different because of all the maximum tax deductions. Minimum contribution rules have changed. They've become quite restrictive in terms of the interest rates and other assumptions that were required for company liability calculations. Yet, we have some range on what we can do even within the current liability calculations to the extent that they are driving the minimum contributions and the maximum tax deductions; therefore, we should be paying some attention to what it is that we're doing.

From the Floor: Aren't there some situations, banks in particular, in which investing in pension plans is viewed as a better use of cash resources?

Mr. Thompson: That may very well be the case, and I think it's the right question to ask. Is putting a lot of money into the plan good use of the company's resources? If the answer is yes, that might call for a different strategy.

Let's look at a situation where we have a surplus, and we want to get access to it. I'm going to loosely categorize access to surplus into two categories. One is removing the surplus from the plan; the other is displacing that surplus by using the pension plan to pay benefits that you might not otherwise have paid from the plan.

Removing the surplus from the plan is in some ways the most difficult thing to do. I've made up some of the numbers for the following case study, but in fact this example is not too different from a client that I have who has expressed interest in the surplus in the plan. They have a pension plan with a large surplus and a 401(k) plan with a very healthy match. They have a retiree medical plan that subsidizes a closed group of inactives who retired some years ago. They do have a medical plan that provides access for retiring salaried employees, but it's a retiree-pay-all plan. The only *FAS 106* obligation that they have is with respect to the closed group of retirees.

Table 1 shows what the surplus looks like. This is the *FAS 87* reconciliation of the funded status of the plan to the company balance sheet. We have a total of $33 million of projected benefit obligation (PBO), which consists of $9 million for retired lives, $3 million for deferred vested benefits, $15 million of accumulated benefit obligation (ABO) for the actives, and $6 million for future pay increases. The plan has $44 million of market value of assets. There's a surplus in the plan with respect to the PBO of $11 million. They have $7 million of prepaid pension costs on the balance sheet, $3 million of prior service cost, and the rest of it just the net gain from all sources.

TABLE 1
WHAT THE SURPLUS LOOKS LIKE

Obligations and Assets		**Annual Cost**	
Retired	(9.0)		
Deferred	(3.0)		
Active	(15.0)	Service Cost	1.2
Accumulated Benefit Obligation	(27.0)		
Future Pay Increases	(6.0)		
Projected Benefit Obligation	(33.0)	Interest Cost	2.1
Market Value of Assets	44.0	Return on Assets	(4.2)
Surplus	11.0		
Unrecognizable Items		Amortization	
Net Transitional Asset	0.0	-Net Transitional Asset	0.0
Prior Service Cost	3.0	-Prior Service Cost	0.3
Net Gain	(7.0)	-Net Gain	(0.3)
Prepaid Pension Cost	7.0	Net Periodic Cost	(0.9)
		Minimum Contribution	0.0

The company is probably looking at this from the standpoint: "We have $44 million of assets and $27 million of ABO, so we have a $17 million surplus." At least that's one way for the company to look at it. That's just too much money siting there wasting away in the pension plan as far as cash goes. In fact, the company has a net periodic income of $900,000. From a financial accounting standpoint, they are making use of those assets in the pension plan, but they're not contributing anything and will unlikely be contributing anything to this plan for some period of time.

From the Floor: What are the assumptions being used?

Mr. Thompson: I have a long-term investment rate of return of 9.5% and a discount rate of 6.5%. I've not assumed any particular cash flow in the retirement plan for benefits, so the investment return is just 9.5% of $44 million. Note that this is an overly simplified example so don't get too tied down to the calculations.

But I think it is an important issue. This has a lot to do with the education of our clients with respect to what these numbers mean. These are the obligations of the plan measured on an ongoing basis. So, yes, I have $44 million of assets and $27 million of ABO or a $17 million surplus when I am valuing this plan on an ongoing basis. But the client might think that there's $17 million there to be had; that is, terminate the plan, get the $17 million, pay some federal income tax, and pay some state taxes—what can I walk away with? It would be very easy for the employer to be thinking that there's maybe $10 million after-tax to be had if they were desperate enough to want to go in there and get rid of that pension plan.

Let's make terminating the plan the first thing that we try to do. Not that this first example of making use of the surplus is something that is going to make financial sense. I just want to look down to the bottom line if they try to do this. Let’s say that they are desperate to get hold of the cash. Therefore, they ask about terminating the plan outright with no replacement plan of any kind. We'll just have the employees rely on this really nice 401(k) plan and revert the surplus back to the company. Just for fun, let's see how bad that looks, keeping in mind that the company probably was looking for $10 million on an after-tax basis if they weren't paying a lot of attention and we weren't talking to them carefully about it.

What are the issues? The taxes are prohibitive, and we will be illustrating that in a second. I think one thing that is always worth keeping in mind is that purchasing annuities with plan assets or certainly distributing the benefits ahead of the time when you need to is probably a bad investment decision for the company. Certainly, you're going to have adverse employee reaction and some adverse community reaction to terminating the pension plan. It's worthwhile to keep in mind that the process of going through a plan termination is expensive and time-consuming. In fact, that's probably a separate issue in and of itself. If the company wants this money really fast, terminating the plan is not necessarily a fast way to get it because it's going to take a while to go through the process. And, of course, even if they're not interested that much in the financial reporting implications, they are something that has to be taken into account.

Let's review the accounting. In Table 2, the column on the left is the initial accounting that we were looking at before. I have very roughly estimated that, because we're going to be purchasing annuities or distributing lump sums, the obligations of the plan are going to become something different from what they were on an ongoing basis. I've estimated a $4.6 million increase in the obligations. I made some very arbitrary assumptions there. The actual effects would depend entirely on the actual provisions of the pension plan: the early retirement subsidies, how young the population is, etc. It is very important for the company to realize that terminating the pension plan changes how much that surplus is to begin with—never mind the tax and accounting implications.

TABLE 2
FAS 88 ACCOUNTING

Obligations and Assets	**Initial**	**Change in Liability**	**Prior to Termination**	**After Termination**
Retired	(9.0)	(0.7)	(9.7)	0.0
Deferred	(3.0)	(0.5)	(3.5)	0.0
Active	(15.0)	(3.4)	(18.4)	0.0
Accumulated Benefit Obligation	(27.0)	(4.6)	(31.6)	0.9
Future Pay Increases	(6.0)	6.0	0.0	0.0
Projected Benefit Obligation	(33.0)	1.4	(31.6)	0.0
Market Value of Assets	44.0		44.0	0.0
Surplus	11.0	1.4	12.4	0.0
Unrecognized Items				
Net Transitional Asset	0.0		0.0	0.0
Prior Service Cost	3.0	(6.0)	(3.0)	0.0
Net Gain	(7.0)	4.6	(2.4)	0.0
Prepaid Pension Cost	7.0	0.0	7.0	0.0
Corporate Cash				12.4

In terminating the plan we will be wiping out all the accounting. In the final analysis, what was a $17 million surplus becomes a $12.4 million surplus, after all is said and done. The company is going to take $12.4 million in cash, before tax.

Let's talk about taxes. Certainly there is going to be federal income tax as long as this is a tax-paying entity. In this case it is a tax-paying entity. There is the excise tax on the reversion, which is the truly onerous part of the taxation. In this case there's simply going to be a 50% excise tax on the reversion because there isn't any other action that the company is taking to avoid that. What about other taxes? What are the state tax implications of getting that reversion, and maybe the city and local tax implications of getting that reversion? We know there are other taxes that the company pays besides federal income and excise taxes. We tend to focus on just those two, but at least we should understand something about what is going on with the other taxes.

Because I'm from the Chicago area, I'm going to be looking at this from the standpoint of Illinois tax and Chicago local tax. I discovered in asking some questions that the state tax implications are really complicated. Obviously, this is something that will vary a lot from state by state. But, whether or not the reversion is considered to be business income or nonbusiness income can have a lot of effect on how any one individual state will tax it. There was a very recent case with Union Carbide in North Carolina where that question was raised and went to the State Court of Appeals, where they decided that it was nonbusiness income although there was a dissenting opinion of one of the three judges that it should have been business income. It was good news for Union Carbide in North Carolina that it was nonbusiness income; that made it nontaxable in North Carolina, as I understand it.

In Illinois you would get a different result. In Illinois, if it's nonbusiness income it all will get taxed at 7.3%. If it's business income, it is allocated among all the places where the company does business. In this particular case this is a company that does business in all states. Spreading it out would probably be a better thing—you may get some of North Carolina's results and whatever the results would be in each state. But this whole issue of whether or not a reversion is business income or nonbusiness income is a particularly unsettled issue right now. Relative to 50% and 34%, 7.3% is small but if, in fact, you are able to get rid of excise taxes, just how much the state tax is could end up being relevant depending upon the situation. Whether or not this would be business income or nonbusiness income in Illinois, I don't know. It might depend on how it's presented. I didn't have the opportunity to get into it in that much detail, but I learned enough to know that this is an important thing to keep in mind. Some states don't have income tax, so you're going to end up getting zero tax in some cases. The tax partner that I talked to in my company was basically saying in the state of Illinois you would want to get it treated as business income and have it spread around.

From the Floor: Would the state tax be deductible?

Mr. Thompson: I don't know whether or not federal income tax would be reduced. I don't know the answer to that. I certainly don't pretend to be an expert on state income tax.

Let's go through the calculation of what the company's got left at the end of the day. According to Table 3, from a cash standpoint they have a $12.4 million gross reversion. They pay federal income tax at 34%—that's $4.2 million. A 50% excise tax under Internal Revenue Code (IRC) 4980 of $6.2 million certainly kills the whole deal, I'm sure. I'm assuming for this purpose it would be nonbusiness income in Illinois, so I'm taxing 7.3%—that's another $900,000. There is, in fact, no Chicago local tax that will be applied. We've ended up paying taxes of $11.3 million and we are left with $1.1 million. The $17 million becomes $1 million from the company standpoint. It's not worth it; the taxes are prohibitive.

TABLE 3
TERMINATE PENSION PLAN
AFTER-TAX EFFECTS

	Cash	**Income Statement**
Gross Reversion	12.4	12.4
Prepaid Pension Cost	0.0	(7.0)
Federal Income Tax	(4.2)	(1.8)
Excise Tax	(6.2)	(6.2)
Illinois State Tax	(0.9)	(0.4)
Chicago Local Tax	0.0	0.0
Total Taxes	(11.3)	(8.4)
After-tax Reversion	1.1	(3.0)

From an income statement, the reversion of $12.4 million is offset by the prepaid pension cost that we already have on the balance sheet that has passed through the income statement. The impact on the accounting for taxes will depend upon the company's accounting for deferred income taxes. The prepaid pension cost is something that should have been tax-affected in their accounting already. I'm assuming it's being tax-affected at the same rate, so I'm left with an $1.8 million offset on the federal income tax. The $6.2 million would not have been passed through any kind of deferred income taxes. Illinois state tax also would have been accounted for on a deferred-tax basis. I have $8.4 million of total offset, and I end up with a $3 million cost for doing this transaction. I end up with $1.1 million net after-tax cash and $3 million of net after-tax expense. This is a lousy thing to do. I'm sure that will be the quick conclusion that the company would come to.

Certainly, everything would come out very differently if you had tax carried forward from previous points in time. Putting this on an after-tax basis I think is the right thing to do. It forces you to think about the entire transaction from a cash standpoint and from an accounting standpoint. Probably the client will tell you what they think is the right number to pop into the equation for, say, state taxes. You don't want to go out to 50 states and try to find out what would be going on in each state, but my guess would be your client could probably tell you what would be the ultimate result because they know something about their allocation of income to the states. At least you will draw their attention to the issue.

From the Floor: Can there be any carryforward with respect to the excise tax?

Mr. Thompson: I don't know that much about excise taxes in general, but I can't imagine having any kind of carryforward from excise taxes in the past that would affect the $6.2 million.

A 50% tax makes the transaction prohibitive as long as you have a tax-paying entity. One worthwhile thing, keeping in mind here if you're dealing with a not-for-profit organization, is that the tax problems go away—even the excise tax, as long as it's a purely not-for-profit organization. And, in fact, *The Wall Street Journal* article was critical of the hoards of hospitals and other nonprofits actually terminating plans. I don't know if those are true terminations, but a lot of not-for-profit organizations have been getting access to surplus because they're not tax-paying entities. They avoid all this.

Another thing to keep in mind, too, is if you have an entity that is not paying federal income taxes and is in desperate need for this money, maybe they're not going to be paying 34%; so you may avoid a piece of tax that way, too. The individual company situations can vary a lot. Never mind the circumstances of the pension plan, but their tax-paying situation is something we should at least understand in articulating to them whether this is a good idea or a bad idea.

That was a bad idea; let's try something else. I have this 401(k) plan. It requires $2 million a year in matching contributions. Instead of terminating the pension plan and trying to take the entire reversion into income, let's instead transfer 25% of that surplus over to the 401(k) plan and put it into a suspense account and use that transfer to meet the matching contribution requirements of the 401(k) plan. Now, I'm not setting up a new plan in conjunction with the termination, but this is a plan that is maintained in conjunction with the termination. I'll allocate the suspense account over whatever period of time is necessary to take care of the matching contribution requirement. You have to do it over at most seven years when you're going through this type of transaction. But, by doing that I'm going to have favorable impact on cash flow at least for the period of time that that will be taking place.

The most important thing, of course, is that you reduce the 50% excise tax under IRC 4980 down to 20% on the other funds that you have not transferred over, dramatically changing the whole tax situation. And you don't pay federal income tax on the 25% of the surplus that you transfer over. Of course, you're also not going to get a tax deduction for what you allocate to the participants' accounts. The most important thing, of course, is changing the 50% excise tax down to 20%. It's worthwhile keeping in mind that the transfer requirement is exactly 25%—no more and no less. You could transfer more than 25% over if you want to, but you're still going to be paying 20% excise tax on the 75%, which is the three-quarters portion that doesn't meet the 25% requirement. We're transferring over exactly 25% in this case.

Now let's see what happens. In Table 4 I have the $12.4 million reversion. I'm going to send $3.1 million over to the 401(k) plan; I still pay federal income tax but only on the $9.3 million. I pay the excise tax of 20% on the $9.3 million instead of 50% on the $12.4 million. I'm assuming you still have the Illinois state tax of 7.3%, which I am assuming applies to the $9.3 million. I don't actually know that for a fact. I didn't ask anybody that question, but I'm assuming that I'll apply it to the same income that passed through the federal return. My tax is now $5.8 million. My actual after-tax reversion is only $3.5 million.

TABLE 4
TERMINATE/TRANSFER TO 401(K)
AFTER-TAX EFFECTS

	Cash	Income Statement
Gross Reversion	12.4	12.4
Transfer to DC Plan	(3.1)	0.0
Net Refund	9.3	12.4
Prepaid Pension Cost	0.0	(7.0)
Federal Income Tax	(3.2)	(0.8)
Excise Tax	(1.9)	(1.9)
Illinois State Tax	(0.7)	(0.2)
Chicago Local Tax	0.0	0.0
Total Taxes	(5.8)	(2.9)
After-tax Reversion	3.5	2.5
After-tax Value of Transfer	2.3	
Total After-tax "Cash"	5.8	

I sent $3.1 million over to the 401(k) plan, so I'm really making pretty good use of that. However, it's not as immediate as the $3.5 million, and I'm not getting a tax deduction for the money that I sent over as I would have for the actual contributions. On an after-tax basis, the $3.1 million becomes $2.3 million. On an after-tax basis, I'm really getting $5.8 million out of the pension plan. If the company was originally looking at this as getting $10 million after-tax from the $17 million, the answer comes out to $6 million. I don't know whether that's good or bad, but the company would be the entity that would be answering that. It may not be what they had in mind in the first place, but they may decide that $6 million is OK. And, is that $6 million worth all the other liabilities that go along with terminating the pension plan? I can't answer that either, but it's a lot better than $1 million. And, in fact, from an accounting standpoint I end up with an after-tax income of $2.5 million on the transaction. That's not as bad either.

That's the most draconian thing I think we can do—terminate the pension plan. Probably the best situation we could come up with, if, in fact, we were going to terminate the plan, is to transfer money over to the 401(k) plan.

Let's take a look at some techniques for displacing the surplus. Instead of going through the agony of trying to get that money out and the adverse effect that would have, let's instead try to pay some benefits from the pension plan that we otherwise would not have attempted to process. It could consist of anything that is actually drawing down on cash flow. We pay it from the pension plan instead. This is a plan that has a pretty good size surplus. As long as what I try to put into the plan isn't all that big, I can go for a number of years without actually getting to a contribution requirement. It's worthwhile keeping in mind that this is a temporary savings because, if we put enough stuff into the pension plan, presumably we will accelerate the day when we will actually have to put money in the plan. If we left the plan alone, maybe this plan would never need a contribution, depending on what happens to the investment returns, but if you put a lot of benefits in there, they'll be putting contributions into the plan sooner rather than later. Let's assume the company's viewpoint on this is to solve cash-flow problems for the next five years because of debt problems and all kinds of things going on with the business. Anything we can do for the next four or five years is saving me money. That's our assumed reference point. Again, it's temporary relief within the pension plan, in all likelihood.

Let's take a look at the retiree medical plan that I mentioned before. What I have in Table 5 is $4 million of obligation for existing retirees. This is a company that booked its *FAS 106* obligation when *FAS 106* was implemented, so they still have a lot of accrued cost sitting there. This is a plan that's actually run a lot of gains for various reasons; in effect, the value of the benefits were initially overestimated to some extent. I have $7 million sitting on the balance sheet, but only $4 million of obligations and roughly zero in net periodic cost; the interest cost is offset by the amortization of the gains. I'm assuming I have annual claims of about $400,000. Is this number big enough from the company standpoint to take action?

TABLE 5
WHAT THE RETIREE MEDICAL PLAN LOOKS LIKE

Obligations and Assets		**Annual Cost**	
Retired	(4.0)		
Deferred	0.0		
Active	0.0	Service Cost	0.0
Accumulated Benefit Obligation	(4.0	Interest Cost	0.3
Market Value of Assets	0.0	Return on Assets	0.0
Surplus	4.0		
Unrecognized Items		Amortization	
Net Transitional Obligation	0.0		0.0
Prior Service Cost	0.0		0.0
Net Gain	(3.0)		(0.3)
Accumulated Benefit Cost	(7.0)	Net Periodic Cost	0.0
		Annual Claims	0.4

Could we take that $4 million and just pay it from the pension plan? Let's take a look at what we would do if we were to terminate the retiree medical plan. We could terminate it entirely and put into the pension plan $4 million worth of pension benefits to replace it. We will continue to give the retiree access to the pay-all retiree plan, but the benefits that they will receive from the pension plan will be ordinary pension benefits and life annuities. The whole purpose here, if we're going to give them level life annuities, is to give them life annuities that are worth more than paying for the full cost of medical benefits today, but, ultimately, with medical trends, might be paying less. Our goal here is not to save expense; our goal here is to save cash. We're going to give them the full value of the subsidized retirement benefits that they might be entitled to.

Now, what are some of the issues with doing that? Can you do it at all? Whether or not you can terminate that plan has a lot to do with what you communicated to the employees and the retirees in the past about the company's right to terminate the plan. This might have something to do with what district you're in in terms of how it would be viewed by the courts if anybody sued. Certainly you're going to have some adverse retiree reaction no matter what you do because you're going to have people who are upset that they're losing something. They may not understand that you are giving them something that is similar in value to what they had before. Of course, you still have *The Wall Street Journal* to worry about.

And the benefits are different. One of the things that you run into in displacing benefits with something else in the pension plan is that you are changing the character of the benefit that you are replacing. We have a benefit that is tied to medical costs. If medical costs go up a lot, retirees get a lot of subsidies from the company. There is a risk, an assurance, and a risk protection built into the current structure. What we're talking about doing here is replacing it with a fixed pension commitment. It's not necessarily a bad thing, but it's different and I think that's an important thing to keep in mind with this and a couple of the other displacement techniques that we're going to be talking about—we are changing the character of the benefit that we're replacing.

Also, you will have to worry about the nondiscrimination issues in the pension plan when doing this. In this particular case, all the people who are affected by these benefits are inactive, so it's going to be a fact and circumstances test with respect to passing 410(b) and 401(a)(4). These are the kinds of benefits that are not likely to cause a lot of problems because they are flat-dollar benefits. The class of employee that actually has the medical subsidies and would benefit in the pension plan wasn't a particularly discriminatory group in the first place. In this particular case it is likely to pass. But you do have to worry about what the nondiscrimination issues are when paying benefits from the pension plan.

From the Floor: Don't you also have to be concerned with the 415 limits?

Mr. Thompson: Good point. You may also have to worry about the potential impact on IRC 415. The analysis of what all the effects are under a qualified plan certainly is something you have to take into account.

From the retiree's standpoint there are some pros and cons to replacing medical benefits with pension benefits. It's not all bad. That you're not tracking future increases in medical costs could be bad from their standpoint. The pension benefits will be taxable to them, whereas the medical benefits would not. In order to get that subsidy they had to go to this company's retiree medical plan to get it. Now they're going to get the value of the subsidy, and they are free to do anything they want to with respect to access. They may want to stay in this plan and still have access and not have to worry about insurability or anything like that.

From the Floor: Couldn't you give them pension benefits that are tied to the cost of medical benefits?

Mr. Thompson: You could do that. That would be another way of doing it. You could solve that problem. I think that that would not be an issue if you were just tied to medical inflation as opposed to just ordinary inflation. Can anybody think of whether or not there is any issue associated with that? I'm certainly not making it contingent on enrollment in any medical plan. I'm not making it contingent upon what the claims actually are. I think it's just a different way of measuring inflation, so I think we could do that if the company wished to.

Certainly, there's an advantage from the retiree's standpoint of now having a funded benefit out of the pension plan. Five years from now the situation that the company is in could be even worse; they may want to go in and completely terminate the medical plan and not replace it with anything. At least they will have a funded pension benefit, so that's something that they didn't have before. There are some good things about it from the retiree's standpoint.

Let's take a look at the financial effects. In Table 6 I am terminating the retiree medical plan. I'm not replacing it with any retired medical benefits, so I am going to completely wipe out the retiree medical plan. I am replacing it with a defined benefit (DB), but it's a defined-pension benefit not a defined retiree medical benefit. Just with respect to the accounting of the retiree medical plan itself, the accrued $7 million of accrued cost will come into income. If this is the only thing that I did, I would have $7 million coming in to income just from the retiree medical plan. There was no ongoing cost anyway because my expense was zero before and it's zero now. The thing I am getting rid of here is the cash requirement for the $400,000 in claims that I had before in the medical plan. That's really the reason for doing this.

However, the questions and answers (Q&A) on *FAS 106* do indicate that, because I am replacing the medical benefits with benefits worth $4 million in the pension plan, I need to recognize the $4 million in the settlement of the *FAS 106* obligations. Just from the pension plan standpoint, this seems to be an ordinary amendment. This amendment was made in conjunction with the termination of the retiree medical plan, and *FAS 106* Q&A #46 indicates that you need to recognize this benefit as part of the settlement of the *FAS 106* obligation.

My read of *FAS 106* is that you do in fact wipe out all of the accounting on the *FAS 106* side. You do take that $7 million in income. There were some people who were initially disagreeing with me about that when I was having some discussions on it, but in the final analysis they agreed. You should know that this is something that took a lot of discussion to make sure that this is, in fact, the right accounting because the language in *FAS 106* addresses whether or not you have the replacement DB plan if you terminate the obligations and replace it with something. My opinion is that, in conjunction with the Q&A, *FAS 106* is saying that the issue is whether or not you're replacing the *FAS 106* obligation with another *FAS 106* obligation. Here we're replacing a defined medical benefit with a defined pension benefit. The pension plan becomes part of the settlement but not a continuation of the existing plan. I can't guarantee that everybody will agree with this, so if you are doing this be prepared for some discussion.

TABLE 6
TERMINATING THE RETIREE MEDICAL PLAN
(MEDICAL PLAN)

Obligations and Assets	Initial	Effect of Termination	After Termination	Annual Cost	
Retired	(4.0)	4.0	0.0		
Deferred	0.0		0.0		
Active	0.0		0.0	Service Cost	0.0
Accumulated Benefit Obligation	(4.0)	4.0	0.0	Interest Cost	0.0
Market Value of Assets	0.0		0.0	Return on Assets	0.0
Surplus	(4.0)	4.0	0.0		
Unrecognized Items				Amortization	
Net Transitional Obligation	0.0		0.0		0.0
Prior Service Cost	0.0		0.0		
Net Gain	(3.0)	3.0	0.0		
Accrued Benefit Cost	(7.0)	7.0	0.0	Net Periodic Cost	0.0
				Annual Claims	0.0

In the final analysis, we end up with the right cash-flow effect—a decreased cash-flow requirement of $400,000. I do end up with some increase in expense because I have the interest cost on the $4 million now. I'm not amortizing the gain anymore, which I was doing under *FAS 106*, so I now have an increase in annual expenses of $300,000. I do have a onetime net credit to income of $3–7 million under the medical plan offset by the $4 million settlement loss in the pension plan. From an accounting standpoint, whether or not this is good depends upon the company's attitude. Is it better to get the income now instead of spreading it over the future? At least I solved the cash issue of the $400,000.

Let's try something else. Going in, let's say the company has decided that they do not want to terminate these plans. They'd rather avoid *The Wall Street Journal* and, besides, terminating plans is going to be too upsetting to employees. What we've been addressing so far is primarily getting access to the cash. What can we do to reduce cash flow that's already there? I have the 401(k) plan, which has $2 million cash-flow requirements. What can I do about that? Can I put that in the pension plan? Sort of. Let’s try that. What we're going to do is stop making matching contributions to the 401(k) plan. I'm going to add a cash-balance feature to the pension plan. For the sake of this example, I'm going to have annual credits that are equal to the average match. If the average match was 4% of pay, I'm going to put in 4% of pay to the pension plan. I’ll credit investment earnings based upon a diversified portfolio of some kind in the cash-balance plan so that they're not losing what they had before in terms of their own investments in the 401(k) plan. When I do all this, I eliminate the cash-flow requirement of the 401(k) plan because now I'm providing the benefits of the match through the pension plan.

Of course, it's not a match anymore. In the situation that this is based on, the company has 100% match on the first 6% of pay. That's a well-thought-of benefit in this particular company. Let's say I have some people contributing nothing, and some people contributing 6% and getting 100% match on 6% of pay. The person who was getting 6% is only getting 4%, so he or she is losing. And the person who was not doing anything is getting 4%, which is great for him or her. You're getting a lot of winners and losers with the way that I'm constructing this. The participants are losing the ability to control their own investments, although I'm going to give them good investment credits. You're going to lose the planning characteristics of your retirement plans, giving an incentive to employees to contribute to the 401(k) plan and get this big match. It just so significantly changes the character of the benefits that you just have to keep that in mind as a very significant issue. You can also do a lot of damage to your average deferral percentage (ADP) test. Here we have a plan that would pass safe harbor rules, yet now they will have to worry about the ADP test.

There are a lot of issues associated with doing it, but you get the right financial effects. Now, with Table 7 I'm not going to pretend that I've done any *FAS 87* analysis. I had a pension plan that had no cash requirement and still doesn't. I had $2 million of cash requirements for the match, but that's gone away. It has the right impact on cash. From an accounting standpoint the $2 million of contributions was costing $2 million. I'm going to pretend that the expense that I'm replacing that with is $2 million. That's going to cost me about the same (the exact way that I credit the contributions to the account and the exact way that I give investment earnings give me about the same accounting effect) just for the sake of illustration.

TABLE 7
REPLACE 401(K) MATCH WITH CASH BALANCE

	Cash	Expense
Before Displacement		
Pension Plan	0.0	(0.9)
Match in 401(k) Plan	2.0	2.0
Total	2.0	1.1
After Displacement		
Pension Plan	0.0	1.1
Match in 401(k) Plan	0.0	0.0
Total	0.0	1.1

There are some different ways that you might do this. You could, instead of giving credits equal to the average 401(k) match, give annual credits equal to the maximum match. Put 6% of pay in everybody's account instead of 4% so you don't get any losers from that standpoint. That's going to cost me money, though, because I was saving some money from those who weren't participating to their full advantage in the 401(k) plan. I could offset that by crediting interest using 30-year Treasury rates, but people are going to be getting a lot less account-balance buildup than they would have had in the 401(k) plan if they invested properly.

What I may then have is an increased cost of crediting the 6% that's offset by the interest arbitrage in the cash-balance plan; maybe that comes out with about the same amount of cost. But I still save the $2 million cash. And, of course, you can reduce expense by simply crediting only the average 401(k) match and still giving them the lower interest credit. I guess you save a lot of money, but that would definitely get you into *The Wall Street Journal*. I still think that one of the most significant things is the change in character of the kind of benefits you're providing.

This company doesn't have a profit-sharing plan, per se, but let's say that the 401(k) plan was a profit-sharing plan, just for discussion. You could do basically the same thing. Stop the contributions to the profit-sharing plan, add the cash-balance feature, give credits equal to the profit-sharing contribution, and credit investment earnings based upon, say, a balanced mutual fund so you'd be approximating what they had before and eliminating the cash-flow requirement for the profit-sharing plan. That's pretty much the same thing as the 401(k) plan. You got rid of the problem of winners and losers because, at least if the credits for the cash-balance plan look like the credits to the profit-sharing plan, there's a little bit more of an equity there between the two structures. If there was any incentive character to the profit-sharing plan (although some people believe it's doubtful in a deferred profit-sharing plan whether that really does exist) that's going away by putting it in the cash-balance plan. And, again, employees lose control over the investments—something that I don't attempt to give them in the cash-balance arrangement. The accounting is similar to that for the 401(k) plan and depends a lot on the accounting techniques for the cash-balance plan, exactly what your interest credits are, and the way you structure the credits to the cash-balance plan.

Let's try one more thing. What I've talked about so far is reducing existing cash-flow requirements by shifting existing benefits over to the pension plan. Let's say this company had a retirement window that they wanted to put in that would offer an incentive for some people to leave. Ordinarily some improved pension benefits would be part of the retirement package, such as a Social Security bridge or things that you ordinarily would pay from the pension plan. Let's say that a significant portion of this package was going to be severance pay. We would want to be able to pay the severance pay from the pension plan, which is exactly one of the things *The Wall Street Journal* article criticized. We're going to try to pay all the severance benefits from the pension plan; therefore avoiding the cash requirement for actually doing it.

What are some of the issues? Well, the severance pay part of this we're going to have to offer to the employee as an annuity payable at normal retirement age. We have to take the severance that otherwise may be a single sum or paid over a relatively short period of time and offer it as an annuity as one of the forms of payment.

From the Floor: Why do you have to offer an annuity?

Mr. Thompson: For the same reason you need to in a cash balance plan—it's a DB pension plan. Unless you structure the severance pay like a Social Security bridge or another form of ancillary benefit structure, any benefit you pay for the pension plan has to be in a form of annuity payable at normal retirement age, whatever the normal retirement age is. I'm just assuming I couldn't do that in part because I already have a Social Security bridge. I could have somebody over age 65 and couldn't consider it as any kind of Social Security bridge. It may actually be a good way to pay the severance. If the person is old enough, maybe they wouldn't want a single sum distribution. Maybe actually having that paid as an annuity with optional forms of payment would be just the right thing. It's not necessarily a bad thing. It requires a little bit more work to do, but it's kind of like creating a cash-balance account. That's really what I'm doing here for all intents and purposes.

You have some nondiscrimination issues. Unless the window group is a separate 410(b) group, these are benefits that are not likely to pass through the safe harbor rules for early retirement windows for nondiscrimination. If you just gave Social Security bridge benefits and, say, five years of service in the pension plan, you might be able to structure them as a safe harbor plan or otherwise pass easily. The severance pay is not going to get through that too well, I would think. What you're probably going to end up doing is having to test this; one of the general tests perhaps. As long as you have not structured the severance in a way that makes it particularly discriminatory, you may not really have a lot of difficulty getting it to pass.

From the Floor: Do you have to offer the severance as an annuity payable immediately?

Mr. Thompson: Yes, if you're going to offer it as a single sum, you would also have to offer it as an immediate annuity. But I'm thinking that it's probably a good thing because for some of the people that may be exactly what they want if they're at retirement age.

From the Floor: What if it excluded highly compensated employees?

Mr. Thompson: You could exclude the highly compensated. Then it's easily a 410(b) group and could easily pass 401(a)(4). But you're trying to save cash. My client was doing something different, but the cash was the issue. When I mentioned to them that there could be some nondiscrimination issues with respect to what they were doing and that some of this would be paid outside the plan, that's not what they wanted. This all has to come from the qualified plan. If it doesn't, then it's not working. Of course, if it was a small number maybe you could get past the nondiscrimination issue without a lot of difficulty.

With respect to the severance pay, you could have some early distribution penalties that you would not have if you just paid it as cash, but you will avoid some Federal Insurance Contributions Act taxation on that so it's not necessarily all that bad from the employees' standpoint in terms of the taxation.

What would the effects be of paying severance from the pension plan in the accounting? I've made some very rough assumptions in Table 8. I get some gains from getting rid of future pay increases with some recognition of prior service costs under *FAS 88*. The key thing, of course, is that I don't change the contribution requirements. For the termination benefits, the company is going to get the hit whether they pay them directly or run them through the pension plan. I'm assuming I have $3 million of liability for the termination benefits. The accounting is probably not a significant issue, as far as the company is concerned in making the decision to do this. Not having to pay any of that $3 million in cash is the point of doing this. If the company had this kind of a situation, it could work out very well.

TABLE 8
PAY SEVERANCE FROM PENSION PLAN

Obligations and Assets	**Initial**	**Window & Curtailment**	**After Window**	**Annual Cost**	
Retired	(9.0)	0.0	(9.0)		
Deferred	(3.0)	0.0	(3.0)		
Active	(15.0)	(3.0)	(18.0)	Service Cost	1.0
Accumulated Benefit Obligation	(27.0)	(3.0)	(30.0)		
Future Pay Increases	(6.0)	(1.0)	(5.0)		
Projected Benefit Obligation	(33.0)	(2.0)	(35.0)	Interest Cost	2.3
Market Value of Assets	44.0		44.0	Return on Assets	(4.2)
Surplus	11.0	(2.0)	9.0		
Unrecognized Items				**Amortization**	
Net Transitional Asset	0.0		0.0		0.0
Prior Service Cost	3.0	(0.5)	2.5		0.3
Net Gain	(7.0)	0.0	(7.0)		(0.3)
Prepaid Pension Cost	7.0	2.5	4.5	Net Periodic Cost	(0.9)
				Minimum Contribution	0.0

Those are all of the main things that I was going to talk about from the quantitative standpoint. There are some other things that I want to mention for you to think about. Anybody who has some comments please feel free to jump in.

Merging two plans together? You could defer the contribution requirements for the underfunded plan. This company does have another plan for hourly employees, but merging the plans wouldn't do a whole lot of good in their case. In other situations, it could be very significant. This technique is easier in a lot of ways than the other ones we have discussed. You have some square-peg-in-a-round-hole issues with the benefit structures that you're putting together that could be administratively burdensome. You have the documents to deal with, but at least, from the employee’s standpoint, the benefits aren't changing. You're just saving cash.

You might try to push your general test to the hilt. If you have nonqualified benefits that are being paid by the company that wrap around your qualified plan, could you amend that qualified plan to add some benefits for highly compensated employees and still pass the general test? This starts to get a little bit more esoteric, but it's something that you could possibly take a look at. It may not necessarily do a whole lot of good from a cash standpoint unless you have a bunch of executives who you'd have to be paying something to in the relatively near future so that you have some cash requirements that are about to kick in. If the nonqualified plan benefits are going to be paid way off in the future anyway, then you haven't really saved much by doing this now. It could take a lot of work to actually justify increasing the benefits.

Not all companies pay their administrative expenses directly from the plan, so you could pay ordinary administrative expenses directly from the plan if you weren’t already doing so. There are a lot of expenses that could be paid directly from the plan if they haven’t already been paid. The company could look into paying employees who are dedicated solely the regular administration of the pension plan directly from the trust. I think basically these people would become employees of the plan. Whether it would be significant enough to go through those hoops would depend on the circumstances.

It’s an area that I haven't really looked into myself, but transferring money into a 401(h) account gets into a lot of issues with respect to maintenance of benefits. It's an awful lot of work, and it's an expensive thing to do. However, once the thing is set up, it tends to work OK. Does anybody have any other techniques for getting access to the surplus that haven't been mentioned here?

From the Floor: How about adding long-term-care benefits to the pension plan?

Mr. Thompson: Do you have a company that was already paying some long-term- care benefits or wanted to put them in?

From the Floor: They wanted to put them in.

Mr. Thompson: Of course, now you're adding benefits. Therefore, I would be using up the surplus assets to pay for something not currently absorbing cash. Do you actually want to structure it in the pension plan as a long-term-care benefit? Is that what you mean?

From the Floor: I don't know.

Mr. Thompson: I'm not quite sure how that works. Having the benefit have exactly the character that you want in the pension plan tends to be difficult. I see one person in the audience indicating that that doesn't work. If you have a group of people that you want to target with some financial resources—perceiving long-term care as one of the things you want them to be able to pay for—give them some money, i.e., a pension benefit.

From the Floor: We have 415.

Mr. Thompson: OK, you have 415 issues perhaps. If you give them some money and articulate to them what this is intended for, you may get some distance out of it that way, perhaps.

I did have one other thing that's been mentioned around my shop. I haven't attempted to do anything like this, but if you have a company with foreign subsidiaries with, presumably, existing retirement benefits of some kind, you could try to pay those benefits from the domestic plan. This may be a very large square peg in a round hole. You get into a lot of tax issues in foreign countries. I would expect some complications attempting to pay any such benefits from the plan and all kind of issues with respect to the economic feasibility. There could be a lot of money associated with something like this depending upon the circumstances.

From the Floor: For IRC 415, how would you define pay?

Mr. Thompson: I assume that this won't work unless I can count foreign pay, so I'm assuming that that can be taken into account. My understanding is that in general if you're not contributing to the plan, then you're, for the time being, not running into tax issues in most countries. When you start paying out the benefits, things can start to get a little ugly, depending upon which country you're in, in terms of the benefits coming out in the foreign country. I have not gone through the issues. Has anybody attempted to do this kind of thing here? This one is a bit more on the edge.

From the Floor: Can you use the surplus to offset the cost of a business transaction?

Mr. Thompson: You have more flexibility these days in splitting up a pension plan that has a surplus into two pieces. If you're going to stay within your control group of corporations, then you're controlled in terms of how that surplus gets allocated among the pieces. If you have a financial transaction involved where part of the company is going outside the control group, you have more flexibility in what happens to the surplus. If that became part of the financial transaction, you come close to fiduciary issues, I think, if in fact you're going to have the transaction contingent upon the use of that surplus. I remember a couple of years ago that question came up in a situation that I was dealing with, and I remember outside counsel raising the question as to whether or not there was a prohibited transaction if the transaction was contingent upon what's happening to that surplus.

There are ways to get access to the surplus. I think probably none of them are easy. Coming back to one of my initial points, I think we do have to pay a lot of attention to the contribution policies for our clients, in terms of whether or not they are really making good use of their resources with the money that's going into the plans in the first place. Somewhere along the line the situation will come up where getting access to that money is important, and it will almost always be hard.

From the Floor: Is there any legislation in the wind?

Mr. Thompson: In terms of legislation, you mean? I've not had any indication of there being any changes in the law with respect to being able to pull money out of pension plans.

From the Floor: What about using pension benefits in lieu of a pay increase?

Mr. Thompson: I would expect that offsetting pay for benefits would require a significant communication effort to make sure that there aren't disastrous employee relations implications.