Back Door Reversions:

Limiting the Use of Pension Assets for Severance Will Strengthen Defined Benefit Retirement Security

3/10/2017

Executive Summary

The use of pension assets to pay for lump sum severance payments during a corporate restructuring is a "back door reversion" that circumvents the Congressional policy against reverting pension assets to pay corporate operating expense. Severance, layoff or other lump sum benefit increases to terminating individuals should be paid out of the company's operating expenses, not from the pension trust, unless the pension plan has a substantial surplus. Congress should require that any ad hoc plan amendment that gives a subset of participants a benefit increase payable in the form of a lump sum must be immediately funded *if* the plan's adjusted target funding level is (a) less than 120% or (b) would be less than 120% after taking into account the cost of the amendment.

When pension funds were used to finance hostile takeovers and the mass layoffs that often resulted, Congress stopped the practice in 1990 by imposing a 50% excise tax on pension asset reversions. Today's "back door reversions" are more insidious. Although ERISA explicitly prohibits the use of qualified pension assets for "layoff benefits," companies can amend a plan at any time not only to offer older workers enhanced early retirement benefits (by awarding extra years of service credit), but even to offer lump sum severance payouts equal to a year's salary or more as part of a corporate restructuring.

The 2006 Pension Protection Act limited this practice somewhat by requiring plan sponsors to pre-fund a plan amendment that increases benefit liabilities to the extent the plan's funding level would fall below 80%. However, as the 2008 stock market meltdown demonstrated, a plan that is 80% funded during a bull market could end up below 60% funded in a bear market – and in default with the Pension Benefit Guaranty Corporation (PBGC) if the plan sponsor declares bankruptcy. For retirees and older workers, the costs imposed by a distress termination or abandoned plan can be severe. When an under-funded plan terminates, many retirees and other plan participants (one in seven on average) suffer a *permanent loss of income* despite the partial guarantees provided by the PBGC. The permanent loss of 30% or more of an individual's *vested but non-guaranteed benefits*, due to various PBGC limitations, can be devastating to the retirees and older workers affected, as the NRLN documents in a companion paper entitled *Pension Guarantees that Work for Retirees.*

The trend toward distressed companies using pension assets to pay severance costs – instead of relying on a restructuring reserve or other corporate assets – is not new to the recent financial downturn. Lucent, United Airlines, AT&T, Verizon, Qwest, Delta and Delphi are among the companies that tapped pension assets to pay corporate restructuring costs. Some companies tap their pension assets for severance payments as they spiral downhill toward bankruptcy and an eventual bailout courtesy of the PBGC. Other companies, left under-funded, cut other retiree benefits across the board. And some others, although the plans remain solvent, use up "surplus" assets that could have benefitted the vast majority of participants if used instead for cost-of-living adjustments or to pay for retiree health care benefits. For example, General Motors used pension assets to pay for nearly $3 billion in lump-sum severance payouts during 2008 – and ended up with such a dangerous degree of under-funding that in early 2009 the Treasury Department restricted the practice as a condition of the federal bailout loan package. In 2012 it terminated its plan for management and salaried retirees entirely.

The most effective way for Congress to protect retirees and other plan participants is simply to **amend Internal Revenue Code section 436(c) [and ERISA Section 206(g)] to require that any ad hoc plan amendment that gives a subset of terminating participants a benefit increase payable in the form of a lump sum must be immediately funded *if* the plan's adjusted target funding level is (a) less than 120%, or (b) would be less than 120% after taking into account the cost of the amendment.**

Severance or lump sum benefit increases to terminating employees should be treated as an operating expense, not as a qualified pension benefit. This reform does not limit the ability of plan sponsors to enhance traditional early retirement benefits (so-called "window benefts"). What it does do is require companies to fund lump sum payouts or other benefit increases that would otherwise cause the plan to worsen its level of under-funding. Ad hoc amendments increasing benefits that are collectively bargained or negotiated between a plan sponsor and bona fide union representatives should be explicitly exempted from this restriction.

In addition, plan sponsors should be given more flexibility concerning the use of surplus assets (e.g., assets greater than 120% of vested obligations). The NRLN recommends that **Congress amend ERISA to permit the reversion of any surplus assets above 120% funding for any purpose that solely benefits plan participants (including early-out payments and funding health and welfare benefits), or for reversion to the company for any purpose if 50% of the reversion amount is distributed as a one-time benefit enhancement to all vested plan participants on a *pro rata* basis** (e.g., a 2% monthly benefit increase). Under each of these circumstances the excise tax on pension reversions should not apply. The calculation of the 120% funding threshold should be subject to IRC Section 420(g), which requires calculation of eligible plan asset transfers using the PPA's corporate bond market segment rates and without regard to the higher discount rates permitted under the MAP-21 funding relief enacted in 2012 (and subsequent extensions).