

But What If a Pension Fund is *Over*funded?

Can local governments put excess pension fund assets to good use?

BY JAMES L. TATUM III

Currently, the consensus is that if a pension fund is less than 100 percent funded, it is underfunded.¹ In other words, if the pension fund does not presently have all the assets needed to pay liabilities in the future (and without consideration of future contributions to the pension fund), the pension fund and retiree benefits are theoretically imperiled. So, out of concern for “underfunded” pension funds, of which there are many, there have been innumerable research papers, news articles, and worried finance directors.

But what if a pension fund is overfunded? Scarcely a word. While the number of pension funds that are underfunded outnumber those that are overfunded, more than a word or two should be spared for the topic.

The City of Ferndale, Michigan, has approximately 171 employees and two defined-benefit plans: the Employees’ Retirement System (ERS) and the Police and Fire Retirement System (PFRS). ERS was closed in 1996.

Since FY 2002, the latest available data, ERS has had no net pension liability,

and consequently, the city has not had to make contributions to the pension plan. From FY 2005 (the latest available data) onward, ERS has had a funded ratio (the ratio of pension fund assets to liabilities) of more than 100 percent. Between FY 2005 to FY 2022, ERS funding was at its lowest—140.8 percent—in FY 2005, and at its most flush—408.3 percent—in FY 2022.

SECTION 401(H) AND THE INTERNAL REVENUE CODE

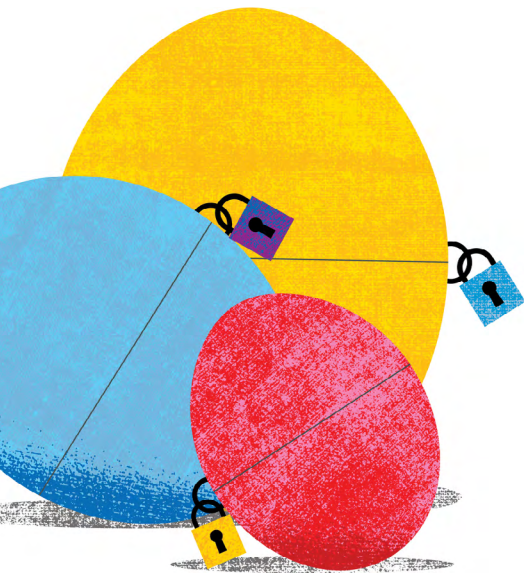
In FY 2020, 105 plan beneficiaries remained in ERS, as did \$20 million in pension fund assets relative to \$6.7 million in liabilities. Comparably, PFRS was 78.7 percent funded.² Could the city transfer assets from ERS to PFRS? No. Nor could the city withdraw excess pension fund assets held in ERS to pay for public services. But maybe, the city’s Finance Department concluded, those excess assets held within ERS could be used to pay for retiree healthcare benefits.

In addition to its pension plans, the city sponsors other post-employment benefits (OPEB) and had set aside \$21.9 million in assets to meet \$50.6 million in liabilities. ERS had too much money;

the city had too little for OPEB (retiree healthcare benefits). So, on March 3, 2020, the city’s Finance Department submitted a request for city council action to authorize the city to create an Internal Revenue Code (IRC) §401(h) account and transfer excess assets into the account from ERS.

Later that year, on November 4, the city received a memorandum from retained counsel on the applicability of a §401(h) account, after which the city council acquiesced to the call for action. It was in FY 2021 that the city appears to have made its initial transfer to a §401(h) account. The City of Ferndale used a §401(h) account to (1) make use of excess pension fund assets that otherwise would have been unavailable and (2) reduce the amount of current tax revenue spent on benefits costs that could otherwise be spent on public services.

Pension plans represent promises made by employers to provide employees income post-retirement. Most rules for these promises, other than those set by states, rest with the IRC.³ No different than private sector employers that offer a “401(k) plan”—the name of which is shorthand for the IRC section that sets



the rules for that plan type—public-sector pension plans operate under the IRC.³ In most instances, the IRC dictates that the monies contributed to a pension plan must be set aside for the exclusive enjoyment of plan beneficiaries.

A section of the IRC may allow for excess assets within a pension fund to be made available for other uses, however; §401(h)⁴ Section 401(h) allows plan sponsors to set aside money in a subsidiary account within a pension plan to pay for postemployment healthcare benefits (remuneration for sickness, accident, hospitalization, and medical expenses). There are two ways, primarily, to deposit money into a §401(h) account: 1) a plan sponsor can make a direct contribution as a part of its total contribution to the pension fund (the portion attributable to the §401(h) account, which may comprise no more than 25 percent of the total contribution); and 2) excess pension fund assets may be deposited into a §401(h) account under what is called a §420 transfer.⁵

Transfers under §420 are subject to strict conditions and limitations, however. Pension plans cannot transfer an amount over what the plan sponsor reasonably expects to pay (directly or via reimbursement) for retiree healthcare benefits, and transfers may occur once per year. Plan sponsors may initiate a “qualified future transfer” whereby retiree healthcare expenses may be “pre-funded” up to 10 years (like §115 trusts typically

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used for OPEB liabilities). The rules, as with almost any section of the IRC, are myriad and any plan sponsor that considers a §401(h) account and §420 transfer should do so with the assistance of counsel that specialize in tax and employee benefits law. To do so without specialized counsel is to risk tax consequences for the §401(h) account and the IRC “qualified” status of the pension plan from which assets may be drawn.⁶

Section 401(h), as it addresses private-sector pension plans, defines “excess” as a pension fund that is at or above 120 percent funded. There is a question as to what extent IRC rules that pertain to §401(h) accounts and §420 transfers apply to private sector and public-sector pension plans equally, with the potential for “looser” rules applicable to public sector pension plans.⁷ In any case, there are reasons that a pension fund would want to retain excess assets, at least to the 110 percent funded ratio. Pension fund assets are invested and are therefore subject to market ups and downs. Excess assets lessen the probability that a pension fund will become underfunded due to bad market returns.⁸

CONCLUSION

Because so much has been said and written about pension funds which, by the estimation of some, have too little money, it may be hard to conceive of the opposite: a pension fund with too much money. But the excess assets in an overfunded pension fund represent opportunity costs: resources that could have been spent on public services. Furthermore, because those monies were contributed for the exclusive enjoyment of plan beneficiaries,

they may not be withdrawn for other purposes—at least, not easily.

Of the 210 retirement plans for which there is recent data in the Center for Retirement Research database on public-sector pension plans (but a small survey relative to the approximately 5,000 plans nationwide), 11, or 5.2 percent, were at or more than 100 percent funded. The City of Ferndale used a §401(h) account and §420 transfer to make use of what would have otherwise been, for lack of a better phrase, wasted assets within ERS. States and municipalities that have overfunded pension plans may (if allowed under strict conditions and limitations set by the IRC) do the same.

Excess pension fund assets may alleviate the financial stresses that some plan sponsors face as they attempt to remain faithful to labor contracts entered with employees and the social contract—a contract to provide public safety, parks and recreation, potable water, and so on—with citizens. **■**

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¹ Tom Sgouros, “Funding Public Pensions: Is Full Funding a Misguided Goal?” Haas Institute for a Fair and Inclusive Society, University of Berkeley, 2017.

² Annual Comprehensive Financial Report, Note 10—Defined Benefit Pension Plans, City of Ferndale, 2020.

³ Internal Revenue Code, Governmental Plans under Internal Revenue Code Section 401(a), Internal Revenue Service, U.S. Government.

⁴ Katie Bjornstad Amin, et. al., “Surplus Assets Locked in §401(h) Accounts—Is There a Key?” Tax Management Compensation Planning Journal, Vol. 45, No. 2, February 3, 2017.

⁵ Thomas Michaud, Memorandum on Funding on Retiree Health Care Benefits, prepared for the City of Ferndale, Michigan, VanOverbeke, Michaud, & Timmony P.C., November 4, 2020.

⁶ Ibid.

⁷ Ibid.

⁸ Mark A. Sarney, “State and Local Pension Plans’ Equity Holdings and Returns,” Social Security Bulletin 63, No. 2, 2000.