ADMINISTRATION

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Plan Termination: Getting it Right

Once the decision is made to proceed with a plan termination, the first step is to get organized. Here are some helpful tips on developing and executing a termination strategy.

BY LAUREN OKUM

A plan sponsor may decide to terminate a qualified pension plan for several different reasons — perhaps because a majority owner has maximized his or her benefit, or the plan sponsor finds that the plan is too costly.

A plan may terminate via a standard termination only if plan assets are sufficient to satisfy all plan benefits, and the plan administrator follows prescribed steps. In contrast, a distress termination is a voluntary termination that is not a standard termination. (Distress terminations and involuntary terminations are beyond the scope of this article.)

IS THE PLAN SUFFICIENT?

A standard termination can only occur when a plan is "sufficient," or fully funded. Defined contribution plans are always fully funded; defined benefit plans may be underfunded, fully funded or overfunded. To determine the funded status, compare assets to benefit liabilities — that is, the sum of lump sums to be paid, annuities to be purchased from an insurance company and amounts to be transferred to the Pension Benefit Guaranty Corporation (PBGC) for missing participants. These liabilities are often larger (potentially 15%-25% higher) than the plan's ongoing liabilities for determining annual contributions.

Plan sponsors of underfunded plans may make a plan sufficient in three ways:

1. by contributing an amount to satisfy all benefit liabilities;
2. by a majority owner of a PBGC-covered[1] plan electing to forgo all or a portion of his or her benefit; and/or
3. by reducing benefits of a non-PBGC-covered plan on a pro-rata basis to make it fully funded.

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> "A plan termination has a higher expected cost but a lower long-term market risk due to its shorter timeframe."

TO TERMINATE OR NOT TO TERMINATE?

When a plan sponsor decides to terminate a plan, it is usually because the plan does not provide enough value for the costs and risks of maintaining it. Plan terminations ultimately eliminate the cost of the plan on the company's financials. However, a plan termination may be cost-prohibitive for an underfunded plan. This is especially true in low interest rate environments, in which lump sums and annuity purchases become more expensive. In short, a plan termination has a higher expected cost but a lower long-term market risk due to its shorter timeframe. The plan sponsor must decide whether it's worth the cost to terminate the plan, or if it's better to take an alternate strategy.

If a plan sponsor decides that a plan termination is too expensive, it has other options to reduce the costs and risks. The most common way is to freeze the plan. For a DC plan, this means no more contributions. For a DB plan, this means no more accruals. A frozen DB plan may still require contributions, but they will be less than an ongoing plan with continued accruals. In this scenario, the plan would continue until the plan is fully funded, which could take several years. (Under the Pension Protection Act, the rules are designed to fund the plan over seven years.) This strategy results in a lower expected cost but a higher long-term market risk due to its longer timeframe.

MOVING FORWARD WITH A PLAN TERMINATION

Once the decision is made to proceed with a plan termination, it is necessary to develop a termination strategy. First, the plan sponsor needs to establish a termination date. Second, it should budget contributions to fully fund the plan by that date, keeping in mind that the ultimate cost to terminate the plan is set by the distribution date rather than the termination date. And third, it should review its asset allocation and adjust for a shorter investment horizon. An investment strategy that mitigates asset fluctuations usually works best. Ideally, the goal is to fully fund the plan by the termination date and allow investment performance to cover any increase in benefit liabilities

[1] Defined benefit plans that are not covered by the PBGC include, but are not limited to, plans covering only substantial owners and plans maintained by professional service employers (defined in ERISA §4021) with never more than 25 active participants.

(due to aging and/or interest rate changes) between the termination date and the distribution date.

In developing a strategy for plan termination, keep the following in mind:

1. PBGC-covered plans may deduct the contribution to fully fund the plan *in the year of plan termination*.
2. Plans that terminate with excess assets are subject to both an excise tax and federal income tax. While there are ways to mitigate these taxes, it is generally desirable to terminate the plan without excess assets.

THE PLAN TERMINATION TIMELINE

The first step for a plan termination is to get organized! A plan termination requires a resolution, plan amendments, participant notices, government filings and annuity bids to be prepared and delivered on a timely basis. Some of the deadlines may be moving targets, since they depend on responses from external entities, so it is important to monitor these deadlines carefully.

The following items are required for all standard plan terminations:

- Board resolution to establish a termination date.
- Plan amendment(s) to freeze participation and benefit accruals (if plan is not already frozen), to reflect any law changes since the plan was last amended and to make any desired plan changes (*e.g.,* offer lump sum distributions if currently not available).
- 204(h) notices to inform affected parties[2] of the benefit freeze.
- Distribution packages to provide affected parties with required notices and allow them to elect their benefit options.
- Distribution of plan assets as soon as "administratively feasible." Generally, this means within one year of the termination date. However, if the plan is covered by the PBGC and/or the plan sponsor applies for a favorable determination letter from the IRS, then distribution must be by the later of 180 days after the PBGC's review period or 120 days after receiving a favorable determination letter.

The following items are required for completing a standard plan termination with the PBGC:

- Notice of Intent to Terminate to inform affected parties and any affiliated union of the proposed plan termination and to provide information about the termination process.
- Notice of Plan Benefits to inform affected parties of their benefits and how they were calculated.
- Standard Termination Notice (PBGC Form 500, including Schedule EA-S) to notify the PBGC of the plan termination.
- Notice of Annuity Information to provide affected parties with information about the annuity provider if benefits are to be distributed in an annuity form.
- Schedule MP (if applicable) to notify the PBGC of missing participants.
- Notice of Annuity Contract to provide participants electing annuities with details regarding the annuity purchase.
- Post-Distribution Certification (PBGC Form 501) to certify to the PBGC that the distribution of plan assets has been properly completed.

The following items are required if a plan sponsor decides to request a favorable determination letter from the IRS:

- Notice to Interested Parties to inform affected parties of the plan sponsor's intent to file for a favorable determination letter and their rights in conjunction with the plan termination.
- Application for Determination for Terminating Plan (IRS Forms 5310 and 6088) to assist the IRS in making their determination.

Often, notices may be combined. For example, the 204(h) notice and the Notice of Annuity Information may be included in the Notice of Intent to Terminate. Similarly, an ERISA 101(j) notice informing participants of benefit restrictions prohibiting additional accruals will satisfy the 204(h) notice requirement.

ADMINISTRATION DURING THE PLAN TERMINATION PROCESS

Until the plan has officially terminated and assets have been distributed, it is necessary to administer the ongoing plan. This includes processing new retirees, collecting contributions, investing plan assets, making participant loans, and filing IRS and PBGC forms.

Plan sponsors of PBGC-covered plans should also prepare for a PBGC audit. The PBGC will audit all plans with more than 300 participants, plans with an indication of problems and plans that distribute benefits before filing a Standard Termination Notice. The PBGC also randomly selects plans with fewer than 300 participants to audit.

AFTER THE PLAN TERMINATION

Finally, plan sponsors should maintain records that demonstrate compliance with ERISA §4041 for six years after PBGC Form 501 is filed. **PC**

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[2] Affected parties include plan participants, beneficiaries of deceased participants, and alternate payees of QDROs.