

TYPES NOT MAPPED YET October 10, 2018 | TTR not mapped yet | Lori W. Jones

# When should you terminate a defined benefit plan? Four influential factors

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According to the Bureau of Labor Statistics, the percentage of civilian workers participating in defined benefit plans has [dropped to 23 percent](#). Of the defined benefit plans maintained by private industry employers, [over one-third](#) are either completely frozen (no additional benefits are accrued, also referred to as a “hard plan freeze”) or partially frozen (the plan is closed to new participants, also referred to as a “soft plan freeze”).

In many cases, the freeze of a defined benefit plan, whether hard or soft, is a preliminary step to the eventual termination of the plan. However, deciding when to terminate a defined benefit plan is not unlike deciding when to invest in the stock market – timing is critical. The investment maxim of “buy low and sell high” is easily stated but almost impossible to execute. Similarly, selecting the optimal time to terminate a defined benefit plan is a challenging task, in large part because of the four factors described below.

### 1. Delay due to approval by two federal agencies

The Pension Benefit Guaranty Corporation (PBGC) is a quasi-governmental corporation within the Department of Labor that oversees the administration of non-governmental defined benefit plans. A plan administrator of a defined benefit plan pays premiums to the PBGC to insure plan benefits in the event that plan assets are insufficient to pay plan benefits. To avoid liability, the PBGC carefully scrutinizes elective terminations of non-governmental defined benefit plans to ensure that plan benefits are fully funded at plan termination.

As part of the plan termination process, the PBGC requires a plan administrator to prepare a number of notices and forms, including PBGC Form 500. ([See this site](#) for PBGC guidance on the steps for terminating a defined benefit plan.) The PBGC has 60 days after receipt of a Form 500 to review the plan termination for compliance with applicable law.

Although not required by law, most plan administrators also apply for a determination letter from the Internal Revenue Service (IRS) confirming that the termination of a defined benefit plan will not disqualify the plan and trigger adverse tax consequences. Unlike the PBGC, the IRS does not have a firm deadline for issuing a determination letter. It can be six to eight months before the IRS assigns an agent to review an application for determination letter. Thus, depending on the issues raised by an IRS agent in his review of a terminating plan, the final issuance of a determination letter by the IRS may occur 12 to 18 months after the application for determination letter is filed.

Technically, benefits can be distributed from a terminating defined benefit plan prior to receipt of an IRS determination letter. However, most plan sponsors will not risk the IRS modifying benefit calculations after final benefit distributions have already been made to participants and beneficiaries.

**The Take Away:** The governmental approval process for terminating a defined benefit plan can take 12 to 18 months after a plan termination date is selected. This prevents a plan sponsor from taking advantage of a change in business or economic conditions that favor immediate plan termination. A plan sponsor can endeavor to shorten the approval process via early collection and review of the plan data required for plan termination. As part of this process, a plan sponsor should identify and, if possible, locate missing participants and beneficiaries; review and amend plan documents; and plan operations as necessary to facilitate the plan termination (e.g., adding a lump sum distribution option).

## 2. Uncertain level of benefit liability

The liability incurred in connection with a defined benefit plan termination depends on two elements; the projected benefit obligation and the value of plan assets. It is important to understand that the Adjusted Funding Target Attainment Percentage (AFTAP), which is certified by a plan's actuary each year, understates the actual liability that will be incurred in terminating a defined benefit plan. This is because the MAP-21 funding rules<sup>1</sup> permit the use of favorable actuarial assumptions in calculating the minimum funding contributions a plan sponsor must make to a defined benefit plan. The actual liability that will be incurred in terminating a defined benefit plan is often significantly higher than otherwise indicated by the AFTAP.

An additional complication is that the cost of purchasing annuities for participants and beneficiaries will not be known until participants and beneficiaries make distribution elections, the plan sponsor obtains bids from annuity vendors and annuities are purchased from the successful bidder. This process occurs months after the designated plan termination date, when benefits are finally distributed to participants and beneficiaries. The cost of annuities is dependent not only on the number of participants and beneficiaries electing annuities, but also on the prevailing interest rate, which could be significantly different from the interest rate in effect when the decision to terminate the plan was first made.

**The Take-Away:** Before making a final decision on plan termination, a plan sponsor should ask the plan actuary to prepare a range of estimates of the projected benefit obligation, using varying interest rates and actuarial assumptions (e.g., the percentage of participants who are expected to elect annuities). This range of estimates will give the plan sponsor a sense of the potential adverse impact of interest rate swings or a high level of annuity elections by participants.

In some cases, plan sponsors have adopted plan design changes to reduce the benefit liabilities that will be triggered by a plan termination. For example, some plan sponsors have implemented lump sum windows under which plan participants have a limited opportunity to cash out their benefits under the plan. Other plan sponsors have chosen to fund benefits through pay status via a purchase of annuities unrelated to a plan termination. Although these plan designs are intended to reduce the benefit liability, it is possible that such plan features could result in adverse selections by participants and beneficiaries, resulting in higher bids from annuity vendors upon plan termination.

## 3. Impact of economic and political climate on asset values

A significant change in the economy between the specified termination date and the date of the final distribution of plan benefits can significantly affect the value of the plan assets available for benefit distributions. An unanticipated drop in the value of plan assets will increase the funds that the plan sponsor must provide to fund final plan distributions. Similarly, significant political events, such as presidential and mid-term elections or domestic or international events that trigger market volatility, can directly affect the value of plan assets.

**The Take-Away:** Liability driven investing (LDI) is a process whereby the investment of plan assets is designed to provide the cash flow needed to meet current and future benefit liabilities. If a plan administrator of a frozen defined benefit plan has not yet adopted an LDI strategy, it should do so before it considers plan termination. LDI may help reduce the impact of market volatility on plans that are moving towards termination.

## 4. Ability of plan sponsor to absorb the financial impact of a plan termination

Finally, a plan sponsor must evaluate the possible impact of a plan termination on its financial reserves and cash flow. Not only are additional, and possibly substantial, contributions to the defined benefit plan likely to be required, but there will be actuarial, legal, and accounting fees incurred in connection with the plan termination. Because the benefit liability will likely exceed that reported on the plan sponsor's prior financial statements, there will be an accounting settlement cost reflected in the plan sponsor's financial statements in the year of the final distribution of plan benefits.

**The Take-Away:** Invariably, additional funds will be required to fully fund a terminating defined benefit plan. Plan sponsors will need to weigh these financial demands against the benefit of eliminating future liability and costs with respect to the defined benefit plan.

Plan sponsors often increase contributions to a plan above the minimum funding requirement in advance of a plan termination. However, a plan sponsor must not contribute too much to a defined benefit plan because recovery of excess plan assets is not permitted until after completion of the plan termination. In addition, the Internal Revenue Code imposes excise taxes on the reversion of plan assets to a plan sponsor. Therefore, plan sponsors should reserve funds outside of the plan to pay for the additional costs and liability associated with the plan termination.

## Conclusion

Warren Buffet, considered by many to be an investment genius, stated the following regarding investing:

"What counts for most people in investing is not how much they know, but rather how realistically they define what they don't know."

This insight is equally applicable in deciding when to terminate a defined benefit plan. The plan sponsor must accumulate available data, prepare estimates, consult with the plan actuaries, attorneys and accountants, consider the impact of the passage of time, and then realistically assess aspects of the plan termination that are outside the plan sponsor's control.



Given the above, there may never be an “optimal time” for the termination of a defined benefit plan. Instead, a plan sponsor should seek an acceptable time for plan termination based on a disciplined assessment of the factors described above and the exercise of its best judgment.

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1. MAP 21 is an acronym for Moving Ahead for Progress, the defined benefit plan funding rules imposed under the 21st Century Cures Act. [↩](#)

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