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PBGC Issues

Planning a Standard Termination—A Checklist for Practitioners

Successfully completing the standard termination of a PBGC-covered pension plan requires careful planning. This article provides a checklist to help you ensure nothing is overlooked.

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Many things have to be done right if a standard termination of a PBGC-covered plan is to be successfully completed. Determining in advance what must be done, who will do it, and when it will be done is critical. If you are involved in planning a standard termination, the following checklist should help you ensure a smooth process.

Making the Termination Decision

The first step in the planning process or, more accurately, the step that is normally taken before you start the planning process, is deciding whether to terminate the plan. That is of course the decision of the sponsor of the plan in its role as settlor of the plan's trust. There are various reasons why the sponsor might opt for a standard termination. For example, contributions may be too volatile, too unpredictable, or both. Perhaps the sponsor believes that the overall costs of a defined benefit plan are too high and prefers to substitute a less expensive defined contribution plan. Or the sponsor may have concluded that the defined benefit plan is not as effective as had been hoped in attracting and retaining employees or in creating the appropriate incentives regarding whether and when employees quit or retire. In some cases, the solution may not be to terminate the plan, but rather to amend it in ways that will do a better job of achieving the sponsor's objectives. If the sponsor ultimately decides to proceed with a standard termination, you should make sure the person or entity with decisional authority (e.g., the sponsor's board of directors) documents the decision appropriately (e.g., through a board resolution).

Ensuring Plan Sufficiency

A standard termination requires, first and foremost, a plan that can be projected to have sufficient assets to be able to satisfy all of its benefit liabilities. If such a projection cannot currently be made, there are two options that often are used to facilitate a near-term standard termination: add to the assets or (in a sense) subtract from the liabilities.

- *Commitment to make plan sufficient.* The sponsor of the plan (or any member of its controlled group) can sign a commitment to make the plan sufficient for a standard termination. The top-up contribution will have to be made in time for the plan to complete its distribution in a timely manner as part of the standard termination process. Although such a commitment is binding, it is conditioned on the implementation of the standard termination. Thus, absent some contractual or other requirement to complete the standard termination, a sponsor who later finds that the sufficiency commitment is too costly can effectively rescind the commitment by withdrawing the standard termination before distributions commence.
- *Majority owner "alternative treatment" election.* A participant who is a "majority owner" (one having a 50 percent or greater interest in the sponsor, taking into account the constructive ownership rules) can facilitate plan sufficiency by electing (with spousal consent) an "alternative treatment" of his or her plan benefit. This alternative treatment calls for the benefit not to be distributed to the extent necessary

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to enable distribution of full benefit liabilities to all other participants. If assets remain after all other benefit liabilities are satisfied, the majority owner's benefit must be paid in full before there can be any reversion to the sponsor or any distribution of excess assets to other participants.

Another option is the "freeze-and-wait" approach, where the sponsor freezes the plan (if not already frozen) in accordance with the ERISA Section 204(h) notice requirements and hopes that ongoing contributions, perhaps aided by favorable investment experience and rising interest rates, will close the funding gap over the next few years. Where lump sum distributions will be available, the sponsor might choose to target a 2012 standard termination, when the changes made by the Pension Protection Act of 2006 ("PPA") to the interest rates used in calculating minimum lump sums—changes that result in lower lump sums—will be fully phased in.

If plan sufficiency for all benefit liabilities is out of reach and the sponsor and the other members of its controlled group cannot afford to maintain the plan, the only options for plan termination are a distress termination initiated by the plan administrator or an involuntary termination initiated by PBGC. These kinds of terminations can be difficult to achieve and, in any event, raise more complex issues that go well beyond the scope of this article.

Dealing with Bargained Plans

A standard termination cannot proceed under Title IV of ERISA where it would violate the terms and conditions of an existing collective bargaining agreement. If the union initiates a formal challenge to the termination, PBGC will not itself resolve the challenge. Instead, it will suspend the standard termination process so that the challenge can be resolved in the appropriate labor relations forum. If you are dealing with a bargained plan, it is important early on to evaluate whether such a challenge is likely and, if so, how best to address that potential challenge (ideally by obtaining the union's consent) so that the standard termination can proceed.

Deciding on Replacement Benefits

In some cases, the plan will have been frozen for some time and the decision as to any replacement benefits for participants (e.g., a new 401(k) plan or enhanced benefits under an existing one) already has been made. Regardless of whether or when the plan was frozen, if a decision about replacement benefits has not yet been made, it should be made and communicated promptly to participants so as to minimize any adverse employee relations impact associated with the standard termination.

Developing a Communications Strategy

Effective communication with the plan's participants is not limited to what goes into the various required notices. It is important to keep them informed as to why the plan is being terminated and what to expect regarding the plan termination, their benefits under the terminating plan, and any replacement benefits they may be getting. PBGC regulations allow you to include additional information with a required notice, provided that the additional information is not misleading. Plan a communications strategy that takes advantage of this flexibility so that participants will have the information you want them to have, not just the information required by PBGC regulations. Complete and effective communications can go far in allaying the concerns of the plan's participants regarding the future and security of their benefits.

Dealing with Plan Assets

Once a decision is made to pursue a standard termination, it is time to revisit the plan's investment policy. The plan's short-term time horizon, coupled with the goal of ensuring sufficiency for all benefit liabilities, may warrant a shift, for example, from significant exposure to equities to an immunized bond portfolio approach so as to guard against the risk that falling interest rates or a steep drop in equity prices will result in plan insufficiency.

Another concern is whether any illiquid assets, such as real estate investments, can be liquidated in time to complete the standard termination distribution within the applicable time limits. It may be appropriate to start liquidating such assets early in the standard termination process so that cash will be available when needed to satisfy benefit liabilities.

Certain expenses associated with the standard termination may be paid out of plan assets, assuming the plan so permits. The key distinction is whether the expenses are associated with the decision to terminate the plan, in which case they would be borne by the sponsor, or are associated with the implementation of that decision, in which case they may be payable by the plan to the extent they are reasonable and necessary. It is helpful at the planning stage to

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have a clear understanding of which expenses may be paid from plan assets and, if so, whether they should be. (Ultimately, the sponsor will be providing whatever funds will be needed to complete the standard termination.)

The flip side of not having enough assets is the "problem" of having too much. If the plan is likely to have excess assets following satisfaction of all of its benefit liabilities, it is important to determine at the outset how the excess will be used. If a reversion to the employer will not be permitted (whether because the plan does not permit it or because the plan provision permitting it will not have been in place for the required five-year period), be sure you understand how the excess will be distributed among participants. Where an employer reversion will be permitted, determine as part of the planning process how you intend to deal with the excise tax on the reversion amount. By establishing a qualified replacement plan or providing for *pro rata* benefit increases, you can reduce the tax from 50 to 20 percent.

Evaluating Plan Amendment Options

Review plan provisions and recent statutory and regulatory changes to determine whether plan amendments are necessary or appropriate. Those amendments needed to retain the plan's qualified status will top your list, but many other plan amendment options may be worth considering. For example:

- *Allowing termination lump sums.* If the plan does not already provide an option for a consensual lump sum upon plan termination, you may want to add one. In deciding whether to do so, consider the cost of lump sum distributions (taking into account the phase-in of the PPA changes to the interest rates used in calculating lump sums) as compared to the cost of purchases of irrevocable commitments (annuity contracts) from an insurer.
- *Eliminating non-protected benefits.* If cost is a significant concern, you may want to amend the plan to eliminate ancillary benefits (e.g., life insurance benefits) or other benefits that are not protected under IRC Section 411(d)(6) and implementing regulations.
- *Freezing benefit accruals.* If the plan is not already frozen, you will almost certainly want to amend it to freeze benefit accruals as of the proposed termination date (or as of an earlier date), regardless of whether the standard termination is successfully completed. This is an important "fail-safe" in case it becomes necessary to defer the proposed termination date or to withdraw the standard termination and initiate a new one.
- *Allocating residual assets among participants.* You may want to amend the plan to address the formula for allocating residual assets among participants.

Regardless of whether the amendment you are considering is necessary to meet a tax qualification requirement, remember that PBGC rules on the timing of the adoption of plan amendments in connection with a standard termination differ from IRS rules. For tax qualification purposes, amendments may be adopted until the end of the applicable remedial amendment period, even if that is after the plan's termination date. PBGC regulations, however, provide that any amendment adopted after the plan's termination date is disregarded to the extent it decreases benefit values or eliminates or restricts optional forms of benefit. Avoid potential problems with respect to any amendments that could result in such a decrease, elimination, or restriction by adopting them on or before the plan's proposed termination date.

There is an exception in PBGC regulations that allows an amendment adopted after the plan's termination date to decrease benefit values to the extent the decrease is necessary to meet a tax qualification requirement. PBGC interprets this exception narrowly, however. For example, assume an amendment is adopted after the plan's termination date to substitute the PPA assumptions (including the phase-in of the interest assumptions for distributions in the 2008 through 2012 plan years) for the GATT assumptions for purposes of calculating minimum lump sum values, thereby decreasing them. PBGC would not allow the plan to base its termination lump sums on the PPA assumptions, notwithstanding that it was necessary for the plan to adopt the PPA assumptions to meet tax qualification requirements, because the plan could have met those requirements by *adding* the PPA assumptions as an *alternative* basis and paying the greater of the PPA-based or GATT-based lump sum. Thus, to the extent the amendment eliminated the GATT basis for calculating minimum lump sums, it was not "necessary" to meet tax qualification requirements.

When dealing with amendments substituting the PPA lump sum assumptions for the GATT lump sum assumptions, focus not only on the timing of the amendment in relation to the termination date, but also on the timing of the termination date in relation to when the PPA changes became effective (i.e., the

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first day of the 2008 plan year). If the termination date was before the 2008 plan year, such an amendment—even where adopted on or before the termination date—is not effective. Thus, a standard termination lump sum with a distribution date (which, for convenience, is assumed in this article to be the annuity starting date) in or after the 2008 plan year would be based on the GATT rather than the PPA assumptions. On the other hand, if the termination date is in or after the 2008 plan year, such an amendment adopted on or before the termination date is effective. In such a case, the applicable phase-in of the interest assumptions is determined based on the plan year that contains the distribution date rather than the plan year that contains the termination date, and the applicable mortality table is the one specified by the Secretary of Treasury on the termination date, taking into account projected mortality improvements under the table through the plan year containing the distribution date.

Updating Plan Records

Plan records need to be in good shape for the standard termination to proceed without a hitch. As you plan, it is important to evaluate any data problems and to determine when and how those problems can be fixed so that benefit liabilities can be determined in a timely manner. If the mailing list of the plan's participants and beneficiaries is out of date, now is the time to make it current so that the notices of intent to terminate and all later notices will reach their intended recipients.

Searching for Missing Participants

If the plan is likely to have any missing participants, decide what steps you will take to meet PBGC's diligent search requirements. If there are any known missing participants (e.g., because prior mailings were returned as undeliverable), start the diligent search process for them well before issuing notices of intent to terminate so that you have a chance of finding them in time to issue those notices properly. Any such steps, such as use of a commercial locator service, can count toward meeting the diligent search requirements provided they are taken no more than six months before the notices of intent to terminate are issued.

Anticipating a Determination Letter Application

Decide whether you will be applying to IRS for a favorable determination letter upon plan termination. In most cases, you will want to do so to guard against the risk that the termination would result in loss of the plan's qualified status. It is important to keep in mind, however, that this will likely result in a loss of control over the timing of the distribution in the standard termination. It is also important to recognize that PBGC, in the event it audits the standard termination, will take the position that it is in no way bound by anything IRS has decided as part of the determination letter process. In any event, if you anticipate applying for a determination letter, make sure to factor into your implementation schedule a realistic estimate of when you expect to get it. Whether or not you apply for a determination letter, remember to adopt all required amendments, as well as all discretionary amendments under which the plan has been operating, regardless of how much time is afforded under a remedial amendment period for an ongoing plan.

Developing an Implementation Schedule

Develop a detailed schedule for implementing the standard termination. Include target dates for at least the following key stages of the standard termination process:

- Earliest and latest dates of issuance of notices of intent to terminate (60–90 days before the proposed termination date);
- Proposed termination date;
- Issuance of notices to interested parties if you will be applying to IRS for a favorable determination letter (7–21 days before the date of the application if the notice is given by posting or in person, or 10–24 days before that date if given by mailing);
- Application for determination letter (by time of filing Form 500 with PBGC);
- Issuance of notices of plan benefits (by time of filing Form 500 with PBGC);
- Filing of Form 500 ("Standard Termination Notice") with PBGC (by the 180th day after the proposed termination date);
- Issuance of election notices (30–180 days before the date distribution commences; may be combined with notices of plan benefits);
- Issuance (if not already provided with the notice of intent to terminate) of notices of annuity information (no later than 45 days before the distribution date);
- Earliest permitted distribution date (the 61st day after the date PBGC received the Form 500);
- Latest permitted distribution date (the 240th day after the date PBGC received the Form 500 or, if an application for a determination letter was filed

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by the time of filing Form 500, the 120th day after receipt of a favorable determination letter);
- Expected distribution date (or range of expected distribution dates); and
- Filing of Form 501 ("Post-Distribution Certification") with PBGC (30 days after completion of distribution of all benefit liabilities, but with penalty relief until 90th day after distribution deadline).

Using the schedule as your guide, make sure that all those involved in the standard termination process (e.g., plan administrator, actuary, attorney, accountant, asset advisor, trustee) have a clear understanding of what role each will play in ensuring that all required steps are completed in a timely and compliant manner.

Evaluating Insurer Options

The selection of an insurer from whom to purchase any necessary irrevocable commitments comes near the end, rather than the beginning, of the standard termination process. Nonetheless, it is often helpful at the planning stage to begin to evaluate options for selecting an insurer and to get at least a general sense of the likely costs of irrevocable commitments (recognizing that those costs may change significantly as interest rates change). Decide what steps should be taken to ensure that the insurer selection will comply with fiduciary standards and the guidance in DOL Interpretive Bulletin 95-1 regarding selection of the "safest available" insurer.

Conclusion

With proper planning, a standard termination process can be completed without problems. By identifying potential issues and concerns early on, you will maximize the likelihood of completing the necessary steps in a timely manner and of easily surviving any PBGC audit of the standard termination. ■

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