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# Pension Plan Termination Guide

Making the difficult decision to terminate a pension plan is no easy feat. The decision can affect employees and stakeholders, and includes many moving parts such as regulatory, budgetary and timing considerations.

The goal of this guide is to help plan sponsors better understand plan termination best practices to ensure a smooth and predictable termination process that meets high standards for efficiency, quality, and communication with employees.

When executed properly, a pension plan termination eliminates plan liabilities by distributing plan assets through a series of lump sum windows or annuities. There are various issues to consider when developing an optimal approach to plan termination. Our program is designed to relieve plan sponsors of the risk, expense and fiduciary responsibility associated with maintaining a defined benefit plan.

Our team of experienced actuaries focus on helping plan sponsors identify and evaluate opportunities and challenges so they are prepared to adequately address the pension de-risking process.

## *"A goal without a plan is just a wish."*

The formal pension plan termination process has many legally mandated and relevant steps. So what should plan sponsors know up front?

**Start planning now**

A plan termination can take a year or more to complete with mandated reporting requirements to both participants and government agencies. Your plan will serve as your roadmap to success, so it's important to have a comprehensive plan that outlines how you will proceed and what actions will need to be taken to achieve a positive outcome.

**Form your team**

Include key players with defined roles and specified deliverables to ensure a well-coordinated process.

**Review your plan design**

A plan document amendment is usually needed to terminate a plan, and consideration should be given about replacement benefits, if needed.

**Know the financial impact**

Plan sponsors should fully understand the financial impact and how the termination will affect their financial status.

**Outline your investment strategy**

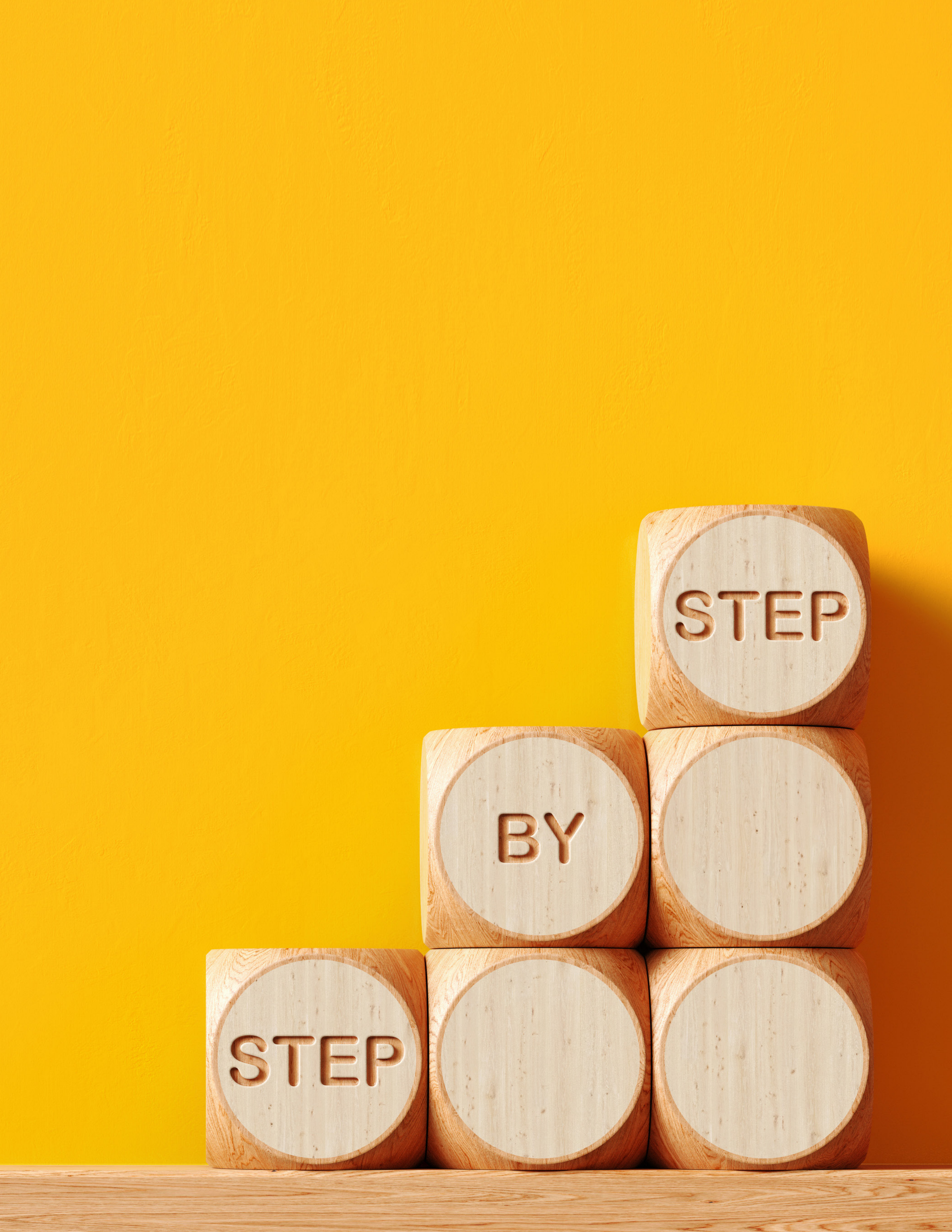
In order to protect the plan's funded level as the termination process proceeds, determine your investment strategy upfront.

**Review the data**

Clean participant data can minimize the termination timeline, so be sure that your data is in good order before you begin the process. There are several required mailings, so it is best to make sure your address database is organized before you begin the communication process. Finding all addresses beforehand will also avoid using the PBGC missing participants program during the final distribution.

**Formalize your communication strategy**

The most significant aspect for many companies is participant communication. The process is complex and subject to rigid legal deadlines, so be sure to have a clear communication strategy in place.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## PLAN TERMINATION

Before we look at detailed plan termination steps, it's important to understand the different plan termination types:

- *Standard termination* – these are known as voluntary terminations.
- *Distress termination* – these are for organizations near or in bankruptcy.
- *PBGC-initiated termination (also known as involuntary termination)* – these occur when the PBGC forces a plan to terminate typically because a plan sponsor is in financial difficulty and presents a risk to the PBGC insurance program.

Companies will typically freeze a plan – either through "hard" or "soft" methods. A soft freeze occurs when no new participants are allowed to enter the plan, but a portion of the plan's existing participants continue to accrue benefits. A hard freeze occurs when all of the benefit accruals have stopped. Although there are some exceptions, once a plan is hard frozen the goal is typically to terminate the plan.

## PLAN TERMINATION STEPS

### Step 1: ***Start planning now!***

One of the most important tasks when preparing for a pension plan termination is ensuring that you have a plan for each stage of the process. Failing to plan is planning to fail, so be sure that you are ready by beginning to plan months – or even years – before you begin. Once the process is started, the deadlines of many of the plan termination steps are set, so verify that all details have been addressed prior to starting your journey down the plan termination path.

The first decision you will need to make is to determine if you want to begin the process before or after you receive a favorable IRS determination letter. Although not legally required, H&H generally recommends that the plan sponsor request and receive a favorable IRS determination letter that:

- Documents that any issues with the IRS – other than operational – have been resolved
- Preserves the deductibility of contributions by the plan sponsor
- Allows distributions to active participants
- Ensures the favorable tax treatment of distributions from a qualified plan
- Documents that distributions rolled over to an IRA are permitted
- Satisfies the requirements by some trustees in order for them to distribute benefits

Unfortunately, it can take the IRS up to a year to issue the determination letter, which can increase the cost of the plan termination and frustrate participants who want their distributions. The delay can also complicate the plan sponsor's accounting, making the final distribution of benefits difficult to meet Pension Benefit Guaranty Corporation (PBGC) deadlines and increase the risk of adverse market changes and investment performance.

Depending on the plan sponsor's goals and risk tolerance, some sponsors file for the IRS determination letter but distribute benefits prior to its receipt. This method, called "compact timing", can condense the termination timeline down to approximately 9 months but should only be considered after weighing the pros and cons of this approach. Our pension experts will help you fully understand this process and work with you to align the necessary steps to put the termination on a faster track. This decision should also be made in consultation with the plan's legal counsel before you begin the process.

## Step 2: ***Get the right team members in place***

A plan termination is complicated with many moving parts, so it's important to identify an experienced team who can deliver on the details. They should understand their project roles and responsibilities, and have specific tasks aligned with target due dates.

**Project team members typically include:**

- Plan sponsor
- HR director and CFO or their representatives
- Actuary
- Benefits administrator
- Attorney
- Investment advisor
- Communications professional
- Trustee
- Annuity consultant and/or annuity providers

Once the team is formed, the plan sponsor should set up a series of meetings and plan for additional administrative resources to assist with mailings, election processing, extra phone calls, and other items involved with the process.

All plans with more than 300 participants, and 33% of plans with less than 300 participants, are audited by the PBGC after distribution of benefits. For this reason, it's paramount that the sponsor's entire team maintain organized documentation through the process. Documentation of the plan termination work must be kept on file for six years following the last distribution.

## Step 3: ***Consider final pension benefit changes and the replacement plan design (if any)***

Next on your list is preparing the termination amendment and considering any replacement benefits for employees. This is the critical time to ask the right questions, such as:

- **What is the objective of the termination?** The organization believes in providing retirement benefits, but maybe the defined benefit plan was too costly or unpredictable. Does the organization have a defined contribution plan? Should one be considered?

- **Are any plan provision changes wanted?** It is not unusual for participants to elect a lump sum distribution if they are given a choice. When the plan has not had a lump sum option available, adding a temporary lump sum window during the plan termination process can lower the overall cost of the project when compared to buying a group annuity for all beneficiaries.

  Participants already in pay status may be offered a lump sum, however, sponsors should request an IRS determination letter if they decide to use this process. The savings would be less for retirees than for non-retirees, but this option may increase the annuity purchase price due to anti-selection. We suggest modeling the cost if lump sums for retirees are part of the plan.

- **Are there any compliance amendments to consider?** If recent legislation, new regulations or other guidance provided by the IRS, DOL or the PBGC has occurred, you may need to amend the plan to comply.

- **How do you want employees to react to the benefit change?** This is a change to a benefit that the employee may not have been expecting, so clear and concise communication is key. Make sure employees understand why the change is happening and how it affects them, and relay the value of the new replacement benefits.

- **How can we make the process easier on employees?** If you have a 401(k) plan, you can make the process easier by enabling participants to rollover their pension benefit into the existing defined contribution plan. Plan sponsors should review the defined contribution plan provisions regarding rollovers to ensure that the plan can accept rollovers during the pension plan termination period.

## Step 4: ***Know the financial impact***

Since losses become a one-time charge to operating income, plan sponsors should educate themselves and others on the accounting impact of a plan termination. Sponsors should weigh the following points during the planning stage:

- **Will additional cash be needed?** The plan actuary should evaluate the unfunded liability on a plan termination basis, not on the IRS funded ratio basis because it can reflect funding relief and significantly understate the plan termination liability. The accounting liability basis can understate the plan termination liability as well. Keep in mind that any additional contributions needed to fund the plan liability are generally deductible, with some exceptions for smaller plans.

- **How long will it take to fund the shortfall?** Whether it's a short-term period such as one or two years or a longer time period such as 10 years, plan sponsors should develop a schedule to fund the plan over a period of time. Rising and falling interest rates can cause the period to fluctuate, so it's important to monitor the funding status periodically and as market conditions change. Depending on interest rates, the plan sponsor may also consider borrowing to fund the plan. Sponsors may want to weigh the cost of the extra cash to achieve predictable payments against the possibility that waiting longer may result in positive future market conditions that may help close the funding gap.

- **Settlement costs may be significant.** Financial accounting for a plan termination may result in a substantial expense because at the time benefits are distributed, all unamortized actuarial losses become a one-time settlement charge. Making additional contributions will not reduce the loss or its recognition in earnings, and the one-time charge could be as high as 50%-100% of the value of the plan assets. Plan sponsors and stakeholders should be fully aware of this accounting impact before the project begins.

## Step 5: ***Consider your investment strategy***

Consulting with your investment advisor is key to ensuring the plan's funded level is protected as the process progresses. The time horizon for an ongoing plan may be decades. However, that may change if the desire is to terminate a plan in five or ten years. Developing a glide path investment policy that considers liability-driven investing or bond matching techniques could lead to a lower percentage of equities and a higher percentage of bonds.

Once the plan termination begins, the remaining life of the plan lowers to around 12-18 months. At that point, equities become a bigger gamble and shifting to cash is also risky because liabilities are still subject to changes in interest rates. A 1% decrease in long-term bond yield could increase liabilities 12%-16%, depending on the liability duration, so investing in long-term bonds could mean less risk than investing in cash and can also minimize the risk of unfunded liabilities increasing. Plan sponsors should also consider whether there are any non-liquid assets (i.e., hedge funds, real estate, intangibles) because these assets cannot be liquidated and may cause a delay in terminating the plan. While working to close the funding gap, plan sponsors should be wary of over-funding the plan due to excise taxes on any surplus that is distributed to the sponsor. Your investment advisor should take these factors into consideration when developing their plan termination fund lineup.

## Step 6: ***Review the data***

Collecting and reviewing data can be a significant undertaking during the plan termination process. Review and address all data issues early, taking into consideration the amount and types of data needed for successful communications with participants. A notice of plan benefits is required and the goal is to display all the data used to calculate the final pension benefit. For most Plan Sponsors, data for current employees is readily available but may prove difficult to find data for terminated employees who have not retired yet.

## Step 7: ***Getting ready to communicate***

Helping your participants understand why the plan termination is happening and how it will affect them is a crucial part of ensuring its success. Significant benefit election decisions must be made during legally constrained time periods, and proactive communications from the beginning is essential.  Education regarding changes to the retirement program helps set expectations, elevates participants' understanding of the process and enables them to seek financial advice. It can also help reduce stress and an abundance of questions during the limited benefit election period. As a fiduciary, plan sponsors are responsible for ensuring that participants are well-informed and ready to make a financial decision.

Before you begin to communicate with participants, develop a communication plan that takes all aspects of the plan termination into consideration. What will the communication say? Who will deliver the message to employees and when? It's important that the planning team develop a list of Q&A's to ensure that consistent and timely messaging occurs.

## Communication best practices:

- **Inform employees of the termination of their DB plan**
  Keep in mind there are legal requirements including formal notices that must be provided to employees 60-90 days before the proposed termination date.
- **Provide a forum for employees to ask questions**
  Help employees make informed decisions by using multiple platforms to communicate with them. With a diverse workforce, consider using multiple platforms to communicate information in a timely manner.
- **Provide written notice at least 45 days before the freeze date**
  If the plan is not already frozen, we recommend freezing it when it terminates so that if the termination is later voided, benefit accruals will not be reactivated.
- **Communicate any enhanced or replacement benefits such as a 401(k) or 403(b) plan**
  Give employees the security of knowing that they will have a replacement plan to save for retirement. This affects their compensation and offers the opportunity to educate employees about other benefits the company provides.
- **Consider other communication needs related to plan sponsor issues**
  If it's a union plan, you will need the union's agreement in order to move forward and terminate the plan. Consider things such as workforce reduction, community issues, public relations and other union issues.

## Call us when you are ready

A pension plan sponsor has a lot of things to consider before moving forward with terminating a plan. They should craft a detailed project plan including deliverables, team members, and the entire process. The professionals at Hooker & Holcombe are experts at working with plan sponsors to proactively assist them throughout a plan termination process. Call us when you are ready to move ahead.

Since 1956, Hooker & Holcombe has delivered the solutions needed to identify, achieve and exceed our clients' retirement plan goals.

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