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THE MECHANICS OF PENSION PLAN TERMINATIONS

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MR. CRAIG A. OLNEY: We are going to go through some of the imagined horrors of voluntarily terminating a defined benefit pension plan. I want to emphasize that it is going to be a voluntary plan termination of a defined benefit pension plan and that it is going to be a single employer plan. We are going to be very noncontroversial as it is a teaching session. We would like to confine ourselves to the actual forms that you need to fill out: the Notice to Interested Parties, the Notice of Intent to Terminate and the 5310.

Part of the material that you have in front of you on plan terminations is a case history that I went through. It started out in the early part of 1978 when an employer came to me and said, "We are going to be closing the plant and we are going to terminate the plan as there will no longer be any employees." The first thing we did was look at the valuation. We didn't go through a "4044 allocation" and we didn't calculate the guaranteed benefits. All we did was take a look at the vested benefits that were almost automatically spun out of the valuation and determined that there was no way that the plan assets were sufficient. By this simple look without a special study, we determined that a decision had to be made prior to terminating the plan as to whether they wanted to make good the insufficiency or go in with an insufficient plan. It was decided quite early in the game that the employer would not only fund the guaranteed benefits and the vested benefits but also the accrued benefits. So they decided early on that they would make the commitment to contribute to the plan any difference between the value of accrued benefits and the value of the assets at the date of termination. With tnis decision made and the plant closing about September of 1978, we started working on the various forms that we would have to file.

The Notice of Intent to Terminate is a letter you can put on your business letterhead. The instructions for this letter and what it must contain are contained in the PBGC Regulation 2604. When you complete this

letter for the PBGC you must go by the numbers and use the numbers contained in regulation 2604. Most of these items are rather self explanatory. Regulation 2604 is a quite readable regulation. Item 9, the proposed date of termination, is when you first make a decision as to the PBGC date of plan termination. This date is not necessarily the date the plant closed down. In our particular case the plant closed in September but the termination date was December 31. The termination date may not be the date that benefit accrual service might stop, although the Internal Revenue Service may consider it the plan termination date. The plan termination date is the date the PBGC uses to determine the end of the 20% phase in 4044 allocations; it is the date on which the valuation interest rate that PBGC may use is fixed; it is the date on which the maximum guaranteed benefits are fixed. This date must be ten days after that of Notice of Intent to Terminate. You will notice that the letter is dated December 21 (it was actually mailed December 19) and the termination date in this particular plan termination was December 31 - ten days after the filing of this letter.

In Item 10, make sure that all documents are signed. Otherwise the PBGC might question the authenticity and ask you to send a signed copy or a signed statement that it is the plan document. If it is an insured plan they would want to see a copy of the group annuity. If it is a negotiated plan send them a copy of the Collective Bargaining Agreement. Make sure it is the current Collective Bargaining Agreement and that it contains all the information that you believe the PBGC may need, otherwise they are going to ask you for it anyway. Send them the latest Financial statement and opinion that you have. In this instance the actual termination was December 31 and the last full financial statement and opinion that we had was for the prior year. We sent them that financial statement and a letter setting forth any changes in the assets.

To complete Item 20 you are going to have to do a little bit of research and estimating. You need to list the number of active participants, whether or not vested, the number of the deferred vested individuals, and the number of retired and disabled participants and beneficiaries and in this particular instance you must give their benefit.

The purpose of Item 21 is to check if you are terminating the plan just prior to many people becoming vested and accruing a guaranteed benefit. The PBGC would like to know if you had deferred this termination 30 days would anybody become vested in those 30 days. The same thing goes for 60, 90 and 120 days. In this instance nobody would have become vested within the next 120 days. In item 23 we say how we are going to distribute the plan assets. We had made the decision that we would get an insurance company single premium quote.

At the date of this letter we were going to give the employees the option of taking a lump sum settlement. After filing this letter we decided that it was a pension plan and we gave everybody an annuity.

You will notice that the first time that we have to do any actuarial work is in Item 24. In this instance, up until now all we were doing was counting people, sending in documents, projecting a little bit as to the number of people who would be there 10 days hence, etc. Now we need to make a statement as to what we believe to be the sufficiency of the assets. As I mentioned in the beginning of this case history, we had an employer who had decided to make a single lump sum payment to make up any difference between the accrued benefits being paid out and the value of the assets on the date of payout. In Item 24 we say that, while we know the plan assets are insufficient, we will make them sufficient. We did not have to go through any of the horrendous calculations that people have been describing and asking questions about, because we were going to give everybody their accrued benefit.

In Item 26 you have to certify that all information is correct. The PBGC requires that this form be filed by the plan administrator or, if not, an attorney. If the actuary is going to sign and file it, he should have the power of attorney from the client.

This is not one of those items like IRS, where if you are authorized to practice before the IRS you can file the forms.

Concurrently with the Notice of Intent to Terminate you also need to notify the employees that you are terminating the plan and that you are filing a termination with the PBGC. Again there is no prescribed form. It is simply a notice to employees that you are filing a form with the PBGC, the date you file it, and when the proposed termination date is. This notice was submitted to the union president to be submitted to his union members, and it was posted in the plant.

You need only file form 5310 with the IRS if you want, in advance, a determination on the effect of the termination on this plan. It is possible that terminating a plan may retroactively affect its qualification and the employer's contribution. You can file form 5310 with the IRS whenever you care to. For a termination you need only complete Parts 1 and 3, and Schedule A. Part 2 need only be completed for those plans merging, consolidating or spinning off assets. Part 1 is simply the name of the employer, the name of the plan and various identification numbers. Part 3 is what kind of plan it is and what you are doing to it and why are you terminating it.

On the reverse side of the form they ask for some additional information that was not requested by the PBGC. First is Item 16 where they go back for the preceding five years and ask for the number of active employees and the change in those active employees.

Item 17, for the first time, requires that you calculate a present value of a benefit. The PBGC hasn't yet asked for the value of the accrued benefits of the terminated plan. The IRS asks for the value of these

benefits, broken down into certain categories; however we still do not have to go through a 4044 allocation or calculate guaranteed benefits.

To calculate the value of these benefits, you can use current market value, or what you believe to be the current market value of these annuities. You can use the PBGC assumptions as an indication of this current market value. However, I have found that in every case, the PBGC assumptions have been low. One thing, if this is an advance determination, people may leave, get salary increases, additional service, go part-time, die, or whatever, near the termination date. Remember that you're only estimating what the amount of the distributable assets is.

The last item of 5310 is Schedule A. It is a listing of the high 25. If you have a group of 25 people, you list them all; if you have a larger group, you list the highest 25 on a salaried basis. The case I'm talking about was a union plan, and we had no idea who were the highest paid. So we didn't file the 5310 Schedule A and it was never asked for. However, if you do have a salary-related plan you will have to estimate the compensation because the plan is not yet terminated and you do not know what salaries will be as of the date of termination.

Assuming that you file this 5310 with the IRS, there is a requirement that you complete a Notice to Interested Parties that is contained in a revenue procedure. This notice has filing deadlines so you cannot file it too soon or too late. Depending on how you give it to the employees, these dates change. For instance, you cannot give this notice less than 7 days or more than 20 days before filing the termination if this notice is given out in person or by posting at the employer's work place. These dates change to 10 days and 24 days if the notice is mailed to interested parties. As this is a termination of a plan, "interested parties" include not only the active employees with an interest in the plan, but also your retirees, your beneficiaries, your deferred vested employees, and anybody else with an interest in the plan. There is not much to say on this notice as it has been completed in the case history, you have the revenue procedure, and the instructions are complete.

We have now completed all the forms for notifying the various people that we are going to terminate the plan. These forms must be done in the proper order. The Notice to Interested Parties must be given out not less than 7 or 10 days, or more than 20 or 24 days, prior to filing the 5310 with the IRS. The Notice of Intent to Terminate to the PBGC must be received by the PBGC 10 days prior to the proposed date of termination and the Notice of Intent to Terminate that goes to the employees must be done concurrently with the notice that goes to the PBGC. There is one interesting item you will notice in our case history. Our date of the Notice of Intent to Terminate to the PBGC is dated December 21 for a proposed termination date of December 31, or exactly 10 days later. Fortunately it was mailed the 19th, so the PBGC received it the 20th and gave us a letter on our timely submission of the notice dated the 21st, for the termination date of the 31st.

After the PBGC has received your Notice of Intent to Terminate, they must determine the sufficiency of the plan assets. Now we get into the calculations. In our case history we have two responses by the PBGC. The first response was not to the case we are talking about, it was another case in which we had no vested benefits. It was obvious that plan assets, if any, would be sufficient as we had zero vested benefits. A plant was set up and operated for 3 or 4 years with a new plan with new employees. When it terminated, the employees obviously could not have had 10 years of service in that plan and be vested (they were vested by the termination of the plan but that is not a guaranteed benefit). The PBGC said " fill out this form and we will give you a sufficiency letter," which they did.

The second letter is where a plan is not immediately seen as being sufficient. That is what happened in our particular instance. On January 22 the PBGC responded to our Notice of Intent to Terminate by acknowledging the receipt on December 20, of our letter dated December 21, of our intent to terminate the plan on December 31. That is all there is in this January 22 letter.

The second letter, dated January 24, is the letter in which the PBGC asks for the information they will need to determine the sufficiency of the plan. They currently have a proposed regulation on determining the sufficiency of the plan (proposed regulation 2615). This regulation provides that the PBGC has three options, one of which is that the plan is clearly insufficient. They will send this notice to the employer. The employer will then have 20 days to explain to the PBGC what he intends to do about it. In our instance on the front end we told them the plan was clearly insufficient and that we intended to make up any difference.

Another option is where the plan is clearly sufficient. In the other case that I was telling you about, there were no guaranteed benefits and there were some assets, so the plan was clearly sufficient. In this instance they will send a letter saying that if you send the proper documents and the plan administrator certifies to the sufficiency, we will send you a letter of sufficiency and you are allowed to distribute the plan assets.

The third option is where the plan is not clearly sufficient. You can prove that the plan is sufficient by calculating the value of the accrued benefits using current market value of an annuity (which will be your best estimate) which the PBGC will sign off on or you can obtain a qualifying single premium annuity quotation from an insurance company which covers all the guaranteed plan benefits. You then compare this value to the assets.

Notice that this letter is dated 24 days after the date of termination. At that time you should have all the information that is necessary to cal-

culate everybody's accrued benefits. You will no longer need to estimate service or benefits or salary (if you have a salary-related plan). You can submit this information to the PBGC or, in our instance, to an insurance company to get the qualifying single premium quotation.

In our case, we submitted to the PBGC our calculation of each individual's accrued benefit and our estimate of its value. We sent this same listing to several insurance companies. By April or May we had received quotations from the insurance companies and the employer made an irrevocable commitment to make up any difference between the annuity quotation and the actual assets in the plan. We gave the PBGC the qualifying insurance quotation and the intent to contribute the difference and they gave us, on June 15, a notice of sufficiency. On July 1, we wrote a check to the insurance company and the trust was terminated. That quite simply is the procedure we went through to terminate a plan. Not once did we calculate the guaranteed benefits. Not once did we go through the horrendous calculations of priority categories 1,2,3,4 and 5. Not once did we have to go through who gets assets and what vested benefits are or are not guaranteed.

There may be instances in which you may have to do their calculations, but in all the cases I have terminated, the plans were either clearly sufficient, such that both the vested and the accrued benefits were covered and the employer received assets back from the plan, or the employer made an irrevocable commitment to fund any difference.

The IRS and the PBGC have gotten their heads together and they want to change the whole procedure. There is a proposed regulation which they call "one stop service." Rather than filing a Notice of Intent to Terminate with the PBGC and a 5310, if you desire, with the IRS; giving out one Notice to Interested Parties that contains one item for the PBGC and another Notice to Interested Parties which contains several other items for the IRS, they have proposed a new form 5310 which covers these items and there would only be one Notice to Interested Parties. Unfortunately this proposed regulation does not describe what this Notice to Interested Parties looks like, or when it must be filed. In reality, if you go through the regulation the only savings is about a 15 cent stamp. If you are filing with both agencies, the proposed regulation requires that you make copies of the 5310 and send two copies of one form to the PBGC. You check whether the form is going to the IRS only or the PBGC only or both. Then the PBGC will forward your listing to the IRS so you do save one 15 cent stamp.

There is another item of savings - if you send it to both the IRS and the PBGC, you no longer have to fill out the high 25 listing. This could be a substantial savings, except you must fill out a similar listing for <u>every</u> employee in the plan. So rather than just doing the high 25, you have to do everybody, and again this is prior to the termination date. You would have to estimate people's benefits. If it is a salary-related plan you would have to estimate their salaries as of the termination date.

There is really no savings here in that you may have to develop this listing of accrued benefits one more time after the termination date to finalize everybody's benefits.

MS. KAREN L. MITCHELL: I would like to talk about alternatives to plan termination. That is what happened during the 8 months, in our example, after the client first decided to close this factory until he decided to terminate the plan. You have much to talk over with your client. He has options. He does not have to terminate his pension plan simply because he's closing down a location. And in fact some of the options which may appear to be plan terminations are not.

First of all we need to define some terms. We've been talking about plan termination without saying what it is. As far as the PBGC is concerned you have a plan termination only if there is no one who is going to continue funding the plan. Your client may have an option about whether or not he wishes to continue this funding. Most of the options that your client will have in such a circumstance are described in PBGC publication number 503. It is a very good publication. It describes things very clearly, so, when a client calls me and says "I have decided that I'm going to close down this factory. What am I supposed to do?" The first thing I do is send him a copy of this. Then we can talk about his alternatives after he's had a chance to absorb some of this information.

A "plan termination" from the point of view of the PBGC is not the same thing as a "partial plan termination" from the point of view of the IRS. A partial plan termination is very imprecisely defined. It seems to be in the eye of the beholder, and the beholder is the IRS. If you think you might have one you may want to talk it over with the IRS. The effect of a partial plan termination is that the affected employees in the plan are vested in all of their accrued benefits, but only to the extent that these accrued benefits are funded. So if the assets of the plan are less than the vested benefits, having a partial plan termination makes no difference. If the plan assets exceed the present value of all accrued benefits you may wish to avoid a partial plan termination. A number of the alternatives to PBGC termination will in fact result in partial plan terminations from the point of view of the IRS. This is something which you must keep in mind.

When you submit information to the PBGC about a terminating plan they will always determine sufficiency on the basis of PBGC assumptions. However, you do not have to use PBGC assumptions for all calculations. For example, when you calculate the present value of lump sum equivalents that you are going to give to employees, you may be able to use other assumptions. If you have been using assumptions different from PBGC assumptions for lump sum benefits under the plan, you are permitted to continue to calculate the lump sums on this basis. If the "actuarial" assumptions produce smaller present values than the PBGC assumptions, this can result in a considerable savings to your client. You can do this only if your plan allows you to give money in a lump sum to

employees who terminate. You can notify the employee that he has the the option of taking his money in a lump sum, and send a different notice to employees with smaller benefits, in the form of a transmittal letter for the employee's check for the present value of his benefits.

You can expect that one employee will choose an annuity. In that case you go to an insurance company and you purchase this one annuity.

The very complicated 4044 allocation calculations hardly ever have to be done. In an actual plan termination, generally, sufficiency or insufficiency can be determined directly and you do not have to go through these calculations in order to do that.

Now to consider the several alternatives to termination. When your client comes to you and you send him a copy of PBGC's booklet 503 you are going to have a meeting with him to discuss the advantages and disadvantages of terminating this pension plan and what his alternatives are.

The first advantage of non-termination is cash flow. If the plan is insufficient to any significant extent, your client may wish to not give all of this money to the PBGC or to the employees immediately. If he does not terminate the plan he can continue funding the plan over the remainder of the 40 years (or perhaps 30 years, depending upon your funding standard account requirements) but the immediate cash outlay will be considerably less. The second advantage to non-termination is that the employer keeps control of the pension fund. If the employer believes that there will be significant gains in the pension fund then he may wish to keep control of these assets. Most of my clients believe that money is worth more than is indicated by either the PBGC assumptions or the actuarial assumptions being used to fund their plans. If they keep control of the assets the gains will decrease their contributions to the plan. Over the long run they will contribute less to the pension fund.

If the assets of a possible terminated plan are somehow tied up with the assets of another plan in such a way that it will be difficult to untangle them, this could be a consideration in termination.

Now, once a year, you have to untangle the assets on paper to file a 5500, but sometimes untangling them in reality can cause a problem. Simply from that point of view, you may wish to continue the plan until the asset situation is simpler.

The final reason that an employer may wish to not terminate his plan is simply public relations. A number of employers think that it is like being opposed to apple pie and motherhood, to terminate a pension plan and deny people their benefits.

On the other hand there are a lot of advantages to termination. The most important one is that once you terminate the plan, you're done. If you do not terminate the plan you need continuing actuarial valuations. You may need continuing audits. You have to file your 5500's every year. You have all kinds of continuing expenses.

I want to give some examples of situations in which you either may or may not have terminations and what your options are specifically. If a factory closes down, yet the parent corporation is continuing, you have three immediate options if the assets exceed the present value of benefits:

1. You can terminate the plan and the employer can take the money. He may be very happy with this option.

2. You can amend the plan so that the excess assets will go to the employees and then terminate the plan and pass out the money to the employees. If these employees are continuing with the employer even though the plan has terminated, this may be a very attractive alternative from the point of view of employee relations.

3. You do not have to terminate the plan even though you have excess assets. You can merge this plan into another plan of the employer. The excess assets then become available to the plan into which you have merged, to reduce the contributions to that plan. When you do this you must pay careful attention to the Section 208 regulations to make sure you do the proper record keeping which is required on a merger.

If you have a potential termination where assets are not sufficient to provide the present value of the guaranteed benefits (the PBGC's definition of an insufficient plan), again you have alternatives.

1. You can freeze the accrued benefits under the plan and continue to fund it. This has advantages in terms of cash flow because the contributions will be smaller than the payouts needed to make up the insufficiency right away. This can increase the ultimate liabilities, however. If the employees continue to be employees of the employer, more of them become vested in these accrued benefits as time passes. At the time you decide to terminate the plan you can amend the pension plan so that the plan only provides benefits guaranteed by the PBGC. Depending on the plan design, this may result in a significant reduction in plan liabilities. This procedure requires much fastidious calculation.

2. You can fold the terminated plan or the potential termination into another plan of the employer. Here again you have the record keeping

requirements of the Section 208 regulations. The advantage of folding a plan in, is that you do not have the continuing expenses. You do not have a separate audit for this plan, you do not have a separate actuarial valuation, and you do not have separate reporting. Once you fold a plan into another plan you are done with it as a separate entity but you have the advantages of non-termination.

The last thing I want to do is describe some situations which may be considered plan termination by the employer, the employees, or the IRS, but not from the PBGC's point of view.

If you combine two pension plans and the result is a third plan, it may appear that the first two plans have been terminated. They no longer exist after the combination. In fact, from the point of view of the PBGC, because the liabilities are continuing to be funded through the third plan you do not have a plan termination. You may have a partial plan termination of both of the merged plans,however, from the point of view of the IRS.

If, as the result of the sale of a corporation or division, the assets and liabilities of a plan are transferred to a new employer, there is no plan termination from the point of view of the PBGC. The plan sponsor and the plan administrator have probably changed, but you have no plan termination.

If your client closes a factory or a division but the assets and liabilities of the plan are absorbed by another plan, this does not constitute a termination of the absorbed plan even though it no longer exists. From the point of view of the PBGC, the liabilities are continuing to be funded.

QUESTIONS AND ANSWERS

Q. In the case where you continue to fund the unfunded vested benefits after the plan has terminated, what are the funding requirements? Does the PBGC require accelerated funding in such a case?

A. No. The plan on which we did this was a new plan after ERISA, which was all on 30 year accruals. PBGC did not request accelerated funding. The parent, the continuing corporation, is a very healthy corporation financially. This is probably why there was no accelerated funding requirement.

Q. If a corporation acquires a division that has its own pension plan and it wants to shift all the employees out of that division and into

a new pension plan, can they shut down the accruals on that division and continue to fund it? If so, what is the vesting status of the people who have less than ten years credit? Do you have to vest these people if you shift them into the parent plan?

A. You can do it and you probably do not terminate that plan. Vesting status is an instance where the IRS would probably determine a partial plan termination, but the PBGC would not determine a plan termination. If the assets are sufficient to cover the accrued benefits then those employees vest in all of their accrued benefits because of the partial plan termination. On the other hand, if the assets are not sufficient to cover even the vested benefits then the partial plan termination, although it exists, has no practical effect. If the employees continue to be employees of the employer then some of them who are not vested at the time that you shut down the accruals will later become vested in their accrued benefit. Vesting service will continue in that case although benefit service does not.

Q. But they do not become immediately vested in that case?

A. They become vested but only to the extent of the assets. If the assets are less than the present value of the vested benefits then they are not vested.