How a Defined Benefit Plan Termination or Freeze Impacts a DC Qualified Plan

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Today’s Agenda

• Overview
• Freeze versus terminate
• Steps to freeze and/or terminate
• Required filings and notices
• DC plan considerations
• Replacement plan design options
• Employee communication
Key Takeaways

After today’s presentation...

• Understand considerations for freezing or terminating a DB plan
• Be familiar with steps required to freeze or terminate
• Be prepared to discuss options for DC replacement plan
• Suggest best practices
Poll Question #1

With what size of employer/plan sponsor do you typically work?

A. Small – 25 or fewer employees  
B. Large – More than 25 employees  
C. Both
Defined Benefit Plans – Still Viable

Defined benefit plans (not extinct – a good fit for some employers)

Advantages ➔

• Attracts and retains talent
• Creates an efficient approach (pool investment risk, expenses and longevity)
• Provides graceful transition to retirement
• Eliminates decisions for employees
• Focuses on providing retirement income to your employees
Defined Benefit - Alternatives

• Cash balance plan
  – Traditional versus cash balance
  – Pay credits and interest credits
• Soft freeze
• Reduced benefits
Poll Question #2

Can an employer terminate a traditional DB plan and immediately implement a new cash balance plan?

A. Yes
B. No
Why Does an Employer Freeze or Terminate a Defined Benefit Plan?

• Reduce cost/accounting volatility
• Reduce long-term cash flow
• Increase short-term profits
• Shift investment/responsibility risk
• Increase competitiveness/global pressures
• Streamline or simplify operations
• Respond to change in ownership/death or illness of owner
Poll Question #3

Have you assisted an employer with the termination of a defined benefit plan?

A. Yes
B. No
Defined Benefit - Hard Freeze

- Stops benefit accruals for all employees
- Prohibits new participants
- Most impactful without terminating plan
- Does not eliminate any unfunded liabilities
- Potential ramifications
  - Employee discontent
  - Ancillary benefit problems
Defined Benefit – Soft Freeze

- All or select group of existing participants continue accruals
- Prohibits new employees
- Minimal immediate impact on cost
- Creates separate classes of employees – “haves and have nots”
Steps to Freeze

• Board of directors resolution (or some type of document/resolution)
• Notice to affected participants
• Plan amendment
DB Plan Freeze - Considerations

- Cost of potential replacement or transitional program
- Employee communication
- Legal and regulatory compliance issue
- Plan nondiscrimination and coverage testing
- Collective bargaining issues
- Asset liquidation issues
Considerations Before Termination

• Funded status – Are assets sufficient to terminate?
  – Note: This is different from the current funded status of DB on SB
• Timing – Typically 12-24 months to complete
• Employee relations

Discuss with your actuary. Complete plan term study?
Plan Termination Study

• Determines termination value of participant accrued benefit
• Confirms if funding is in place to cover present value of benefits
• Used as a tool in determining asset allocation strategy
Plan Sufficiency

- Non-PBGC covered plans
  - Plan sponsor makes additional contributions
  - Reduce benefits on a pro-rata basis
  - Follow allocation of asset provisions in plan

- PBGC covered plans
  - Plan sponsor makes additional contributions
  - Majority owner(s) elect to forgo benefits
Key Decisions – Early Planning

- Set an effective termination date
- Clean up data
- Review plan document and administrative policies
- Consider plan amendment timing
- Develop an interim investment strategy
- Determine participant distribution alternatives
- Develop excess assets options (if any) – reversion of assets
# Plan Termination Steps

<table>
<thead>
<tr>
<th>Step</th>
<th>Timing</th>
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</thead>
<tbody>
<tr>
<td>Resolution / Plan Amendment(s)</td>
<td>Generally by date of plan termination (DOPT)</td>
</tr>
<tr>
<td>ERISA 204(h) Notice</td>
<td>At least 15 days (45 days if large plan) prior to freeze</td>
</tr>
<tr>
<td>Notice of Intent to Terminate</td>
<td>At least 60 days but no more than 90 days prior to proposed DOPT</td>
</tr>
<tr>
<td>Notice to Interested Parties</td>
<td>At least seven days but no more than 21 days prior to filing Form 5310 (3-day grace)</td>
</tr>
<tr>
<td>IRS Form 5310, etc.</td>
<td>Prior to filing PBGC Form 500 (if distributions intended to wait for IRS LOD)</td>
</tr>
<tr>
<td>Notice of Plan Benefits</td>
<td>Prior to filing PBGC Form 500</td>
</tr>
<tr>
<td>PBGC Form 500, etc.</td>
<td>No later than 180 days after DOPT (no earliest date, but DOPT is logical earliest date)</td>
</tr>
<tr>
<td>Notice of Annuity Information</td>
<td>At least 45 days prior to distribution of plan assets</td>
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# Plan Termination Steps

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<th>Step</th>
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<tr>
<td>Distribution of Plan Assets</td>
<td>Generally no more than one year after termination date (exceptions apply)</td>
</tr>
<tr>
<td></td>
<td>Alternative: 240 days after Form 500 is filed. Extended to 120 days after LOD if Form 5310 is filed if Form 500 is filed.</td>
</tr>
<tr>
<td>Notice of Annuity Contract</td>
<td>No later than 30 days after distributions are completed</td>
</tr>
<tr>
<td>PBGC Form 501, etc.</td>
<td>No later than 30 days after final distribution is made (no penalty if 90 days after distribution deadline)</td>
</tr>
<tr>
<td>Final PBGC premium filing</td>
<td>Earlier of the regular filing date for the plan year in which final distribution occurs, or the date the post-distribution certification is filed</td>
</tr>
<tr>
<td>Final Form 5500 / 5500-SF / 5500-EZ</td>
<td>No later than last day of seventh month after final distribution</td>
</tr>
</tbody>
</table>
Plan Termination Steps

1. Proposed termination date
   - Request for IRS determination letter must be submitted before filing Form 500 to qualify for extended distribution deadline
   - Notice of Intent to Terminate
     - Notice of Plan Benefits & Form 500 (NOPBs must be issued before filing Form 500)

2. PBGC review period
   - End of PBGC Review
     - Receipt of IRS Determination Letter

3. Distribution Deadline
   - Notice of Annuity Information must be provided at least 45 days before actual distribution
   - Distribution Deadline

4. No Request for IRS Determination Letter
   - 60 days
   - PBGC review period

5. 120 days
   - 180 days
Determination Letter

Advantages

• Protection from risk of disqualification
• Protection from problems if the plan is chosen later for examination
• Protection both for the client and the service provider
  – No reliance on opinion letter or advisory letter for plan term
• Extension of time for final distribution of benefits for PBGC-covered plans
Determination Letter

Disadvantages

• Does not establish validity of termination
• Does not establish that benefit distributions were correct
• Issues discovered by the reviewing agent are no longer allowed to be cleaned up without penalty
• More likely to be chosen for an audit “to see if the distributions were made as proposed by the taxpayer”
• IRS user fee ($2,300 for single employer; $4,000 for multiple employer)
Potential Amendments to DB Plan

• Legislative update (make sure plan is “current”)
• Distribution options – lump sum
  – Critical to review this provision (common to add lump sum)
• Benefits for owners
Overfunded DB Plans

- Assets remaining after satisfaction of all benefit obligations may revert to the company (if plan provides)
- Plan provision to permit reversion must have been in effect for at least five years (or since inception of plan, if less)
Poll Question #4

Can the “standard” reversion excise tax (for an overfunded DB plan) be reduced?

A. Yes
B. No
Excise Tax on Excess Assets

- IRC 4980 imposes 50 percent excise tax on reversion
- 50 percent excise tax is reduced to 20 percent if one of the following applies:
  - Employer establishes or maintains a qualified replacement plan
  - Employer provides pro-rata increases
  - Employer is in liquidation or bankruptcy
## Excise Tax on Excess Assets

- **Example** - $4 million in assets; $3 million in benefit liabilities
- **Alternatives**
  - Take $1,000,000 reversion
  - Allocate $200,000 to participants and $800,000 reversion

<table>
<thead>
<tr>
<th></th>
<th>50% excise</th>
<th>20% excise</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reversion</td>
<td>$1,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Ordinary tax</td>
<td>$340,000</td>
<td>$272,000</td>
</tr>
<tr>
<td>Excise tax</td>
<td>$500,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>Remaining</td>
<td>$160,000</td>
<td>$368,000</td>
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Qualified Replacement Plan

• At least 95 percent of active participants in terminated plan that remain as employees are active participants

• A direct transfer of 25 percent (or more) of the surplus of the original plan is made to the qualified replacement plan

• The funds are allocated under the plan to accounts of participants
  – In the plan year in which the transfer occurs; or
  – Credited to a suspense account and allocated to the accounts of the participants no less rapidly than ratable over seven years beginning with the year of transfer
Pro-Rata Benefit Increase

- 20 percent (or more) of the surplus assets are allocated to participants to provide pro-rata benefit increases in proportion to present value of accrued benefits
- Any benefit increase must meet the nondiscrimination requirements of IRS 410(b) and 401(a)(4)
Pro-Rata Benefit Increase

• A benefit increase that does not meet these requirements will not result in a decrease in the excise tax rate from 50 to 20 percent, but will reduce the amount of the reversion.

• Any benefit increase that eliminates a reversion entirely will eliminate the excise tax.

• If a participant cannot receive share due to 415 limit, it is okay to reallocate to the others.
Exception to Excise Tax

- Reversion is transferred to an ESOP that meets certain conditions
- Reversion to an employer that at all times has been exempt from federal income tax; or
- Governmental plans within the meaning of IRC 414(d)
How Can a DB Freeze or Termination Impact a DC Plan?

• Plan design/enhancements
  – DC plan – review, enhance, amend, etc.

• The DC plan is now the only plan for employees
  – Review participation, savings rates, etc.

• DB distribution – lump-sum rollover (IRA or to 401(k) or 403(b) plan)
Replacement Plan Design Options

- Enhance current DC plan
- Add a DC plan
- Executive benefits/nonqualified plan
Poll Question #5

Have you assisted an employer with the design of a replacement DC plan?

A. Yes
B. No
Enhance Current DC Plan

First option should most likely be to enhance the current DC plan

• Employee contributions
  – Salary deferrals - 401(k), 403(b), or 457(b)

• Employer contributions
  – Employer match
  – Employer non-elective

• Rollover contributions
Enhance Current DC Plan

• Employee contributions
  – Salary deferral plan
  – Eligibility and entry dates
  – Automatic enrollment
  – Automatic increase
  – Roth
  – Safe-harbor plan
Enhance Current DC Plan

• Employer match contribution (add or enhance)
  – Uniform structure
  – Non-uniform structure (tiered match based on certain factors, such as years of service)
Enhance Current DC Plan

• Employer non-elective contribution (add or enhance)
  – Uniform structure
  – Non-uniform structure (integrated, comparability, WAVE, tiered, or points allocation)

➔ In a DB plan term, the most common approach is for a portion of lost benefits to be “replaced” through the enhancement or addition of an employer non-elective contribution
Enhance Current DC Plan

• Rollover contributions
  – Make sure rollovers from DB plan are allowed
  – Roth rollovers allowed
  – Lump-sum rollovers must be elected by participant
Plan Design Considerations

• Replacement of lost benefits (replacement ratio study)
  – Identify which employees will be impacted most
  – Potential for great flexibility
  – Communication of additional contribution is vital
• Is goal to replace lost benefits or target certain employees?
• Nondiscrimination test
Add a DC Plan

Potential reasons:

• Separate plan desired (two-plan approach)
• Plan limits and/or testing considerations
  – 410(b) minimum coverage, 415 limits, top-heavy, etc.
Employee Communication

Critical component

• Accurate information from the beginning is vital
  – Already a tenuous period
  – Revisions looked upon as unfair

• Timeliness is important, as well
  – Employees need appropriate time to make decisions
  – IRS deadline to distribute met because of good communications
  – PBGC will review dates of all required employee disclosures

• Face-to-face meetings explaining changes and options is best practice
Executive Benefits/Nonqualified Plan

- Replacement of lost DB benefits may be difficult under a qualified DC plan for HCEs
  - Typically closer to retirement with less time to make up lost benefits
  - Also may be limited by 415 or 401(a)(4)
- Nonqualified plan may be a viable option
  - Targets certain executives
  - No limits
  - Nondiscrimination testing does not apply
  - Various designs/options available
  - 409A plan requirements
Case Studies - Examples

Examples of retirement program changes

• Company A – DC replacement plan
• Company B – DB traditional – replace with cash balance
• Company C – DC replacement plan and NQ plan
Company A - DC Replacement Plan

Current retirement program

• 401(k) plan
  – Salary deferrals (four percent automatic enrollment)
  – Employer match (50 percent of first four percent with a two percent max)
  – Employer non-elective – none

• Defined benefit plan
  – Traditional
  – Benefit formula (two percent of average salary times service)

• Nonqualified plan
  – None
Company A - DC Replacement Plan

New retirement program

• 401(k) plan
  – Salary deferrals (four percent automatic enrollment, added auto increase two percent per year with a ten percent max)
  – Employer match (50 percent of first four percent with a two percent max)
  – Employer non-elective – non-uniform structure (3 percent - 1-10 YOS, 4 percent - 11-20 YOS, and 6.5 percent over 20 YOS)

• Defined benefit plan
  – Traditional – hard freeze
  – Not sufficient to terminate – will continue to fund

• Nonqualified plan
  – None
Company B – Traditional DB to Cash Balance

Current retirement program

- **401(k) plan**
  - Salary deferrals (no automatic enrollment)
  - Employer match (50 percent of first six percent with a three percent max)
  - Employer non-elective – none

- **Defined benefit plan**
  - Traditional
  - Benefit formula (two percent of average salary times service)

- **Nonqualified plan**
  - None
Company B – Traditional DB to Cash Balance

New retirement program

• 401(k) plan
  – Salary deferrals (added auto enrollment and auto increase)
  – Employer match - none
  – Employer non-elective – (three percent)

• Defined benefit plan
  – Traditional – hard freeze – sufficient to terminate
  – Cash balance plan (pay credits – HCEs – 415 limit and NHCEs – three percent of salary, interest credit – five percent)

• Nonqualified plan
  – None
Company C – DC Replacement and NQ Plan

Current retirement program

• 401(k) plan
  – Salary deferrals – automatic enrollment (three percent default)
  – Employer match (100 percent of first three with a three percent max)
  – Employer non-elective – none

• Defined benefit plan
  – Traditional
  – Benefit formula (two percent of average salary times service)

• Nonqualified plan
  – None
Company C – DC Replacement and NQ Plan

New retirement program

• 401(k) plan
  – Salary deferrals *(QACA 3% and 1% auto increase with 6% max)*
  – Employer match *(QACA enhanced match - 100% of first 4% with a 4% max)*
  – Employer non-elective – comparability allocation (three groups)

• Defined benefit plan
  – Traditional – hard freeze
  – Not sufficient to terminate – will continue to fund

• Nonqualified plan
  – 409A plan – Key executives – employer discretionary contribution; employee deferrals allowed
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