JOURNAL of PENSION BENEFITS

ISSUES IN ADMINISTRATION, DESIGN, FUNDING, AND COMPLIANCE
Volume 29 • Number 4 • Summer 2022

When to Terminate a Defined Benefit Plan

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The author in this article outlines the optimum times to consider terminating a defined benefit plan and the steps to be taken to achieve that end.

A quote from William Shakespeare, who obviously was a pioneering pre-ERISA pension consultant, when discussing when to terminate a defined benefit plan.… "BETTER THREE HOURS TOO SOON THAN A MINUTE TOO LATE—LET EVERYMAN BE THE MASTER OF HIS TIME." Words from almost half a millennium ago that still ring true today.

A defined benefit plan is not forever. If it is not terminated at the proper time, there can be serious consequences, ranging from taxable income to substantial excise taxes. The main culprit, among others, is overfunding. This article outlineas the optimum times to consider terminating the plan and the steps to be taken.

The two most apparent reasons for terminating a plan are adverse business conditions or the sale of the sponsoring employer.

Adverse Business Conditions

An employer can very simply find itself in the position of not being able to continue to maintain the plan. Required minimum contributions can no longer be made and administrative fees may be too costly for the current climate. In most cases the plan will

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not be overfunded and benefits will probably have been frozen. If the plan is subject to Pension Benefit Guaranty Corporation (PBGC) coverage, the employer must fund the benefits for the nonowners. If it is a business controlled by one individual, the owner would have the option of funding his or her benefit or taking a substantial owner waiver and only receiving benefits to the extent that assets permit. This is known as a Standard Termination. If the plan does not have sufficient assets to meet the obligations for the non-majority-owner employees, the employer can file a Distress Termination. Under this option, the PBGC takes over the plan assets and will be responsible for future monthly pensions (which is available in very limited circumstances).

Sale of Business

If the sponsor is selling the business, the purchasing entity generally does not want to be responsible for the defined benefit plan. There are different approaches to handling the plan if the sale is a stock sale or an asset sale. The structure of the sale generally is established in the early stages of a negotiations, so there is time to develop the proper strategy. If it is a stock sale, the buyer will agree to take over the plan or ask for it to be terminated. It is critical for the seller to know the status of the plan's funding BEFORE the final details are completed. If the plan is underfunded, the purchaser probably will not want to take over the plan or it will take the underfunding into consideration with respect to the purchase price. Often the underfunded liability is at least a dollar-for-dollar reduction to the purchase price (if not greater to account for administrative burden, expenses, and future investment risk). An exception to this might be if the purchaser had an extremely overfunded defined benefit plan and could then absorb the additional liability to alleviate its overfunding and put those excess assets to tax-advantaged use.

If it is an asset sale, and the seller can or will still retain the business in some capacity, there are choices. If the plan is overfunded, the seller may want to delay terminating the plan and keep accruing benefits, especially if there is a future income stream (receivables, consulting fees, etc.). The other existing participants, if any, have terminated employment and therefore can be paid out (although they often cannot be forced to receive a distribution absent a plan termination). In this case, any overfunding can remain in the plan and eventually inure to the owner's benefit. If the plan was terminated prior to the sale, the other participants would potentially share in the overfunding or the owner might lose nearly all the value of the overfunding through income and excise taxes.

Now let us examine the less obvious reasons as to why a plan should be terminated. A business owner should evaluate whether plan termination is appropriate in the following not uncommon scenarios:

- Business owner is at or near normal retirement age,
- Business owner's plan benefits are at maximum levels,
- Business owner's future compensation will be declining, and
- Plan is fully funded.

None of these circumstances should come as a surprise, thus allowing for the proper planning to avoid any adverse situations.

A plan termination may be appropriate in these situations to mitigate the risks associated with the following:

- Overfunding near retirement age,
- Investment choices,
- Maximum benefits obtained (Section 415 limits),
- Required distribution considerations, and
- Anticipated change in demographics.

Overfunding Near Retirement Age

You are approaching age 62, you have $3.4 million in your pension plan, and you expect to have at least five more years of substantial compensation. Your actuary has advised you that you are well above the $3.1 million maximum lump sum currently permitted and you expect significant future investment earnings. You also have a 401(k) plan that you are contributing to at the maximum allowable level.

One option is that you can continue to contribute at a maximum level to the 401(k) plan, almost 70,000 per year and no longer contribute to the pension plan. Yes, you still would be receiving a current deduction but, assuming significant investment earnings, you are continuing to increase the overfunding in the pension plan, which may be less advantageous than the current deduction. Project ahead five years, you're ready to retire and/or your compensation stream has greatly declined or stopped. The pension plan would be extremely overfunded. Assuming similar regulations are in effect at that time, the excess assets would

become taxable income and would be subject to a 50 percent excise tax. DISASTER.

You can reduce or eliminate the excise by transferring some or all of the excess assets to a qualified replacement plan (QRP), in this case your existing 401(k) plan. The QRP holds the excess assets and allocates them as employer contributions, up to the annual Internal Revenue Service (IRS) limit (which is no more than 100 percent of compensation). If the excess assets are allocated within seven years, there are no excise taxes on the transferred amount. While this sounds attractive, the QRP approach wouldn't be effective in the above situation because, by waiting until the end of your career when compensation has declined and the excess funding has ballooned with investment earnings, your compensation and/or the IRS allocation limit is not high enough to amortize the excess over seven years. This means you would have to pay at least a 20 percent excise tax on the unallocated amount. Better than 50 percent, but still not a good outcome.

If you had instead elected to terminate the plan at age 62, the result would have been more favorable. In that case, the $300 thousand in excess assets could have been transferred to the 401(k) plan as a QRP. Since you will have recurring annual income over $60 thousand, the excess assets would be allocated to your 401(k) account to the maximum extent each year. The excess assets would be fully allocated within approximately five years, and you would not pay any income or excise taxes on the excess assets that were transferred. Of course, during that five-year period you would still be permitted to make catch-up deferrals, but would not be able to make other deductible contributions to a plan. Thus, while you lose the deduction for those five years, you avoid the significant excise taxes, which is generally more advantageous. The timing definitely mattered.

Investment Choices

Let's say you have invested well, you have a fully funded defined benefit plan, and you are near retirement age. Let's further assume that your benefit cannot increase because you are either at maximum limits or future compensation will not increase. You may have some investments in the plan that can suddenly be in a position to take off. An example could be a real estate investment that has had a nice annual return but is negotiating to be sold for a very substantial profit. It is currently valued at 250,000 but could conceivably double if the sale goes through. This would add 250,000 of assets to your plan and could cause an uncomfortable overfunding issue. Giving it some thought:

- I cannot make future contributions because I am at maximum limits
- Why not terminate the plan, transfer my investments to an Individual Retirement Account (IRA) or my 401(k) plan (existing or new)

Now, I have protected myself from a possible seriously overfunded plan and can enjoy the fruits of the investment in a plan that does not have limitations on my ultimate benefit.

Maximum Benefits Obtained

Let's assume you have reached the plan's normal retirement age of 62 and you have a defined benefit plan with a benefit formula equal to 100 percent of average compensation. Let's assume your average compensation was $120,000 and you have accrued a monthly pension of $10,000. For purposes of this scenario, you do not expect your compensation to increase in the future. The current lump sum value of your benefit is approximately $2,032,000. Normally when someone defers retirement, their benefit is actuarially increased to account for the fact that they delayed payment of the benefit. The monthly pension would increase and the lump sum would also increase. However, since the maximum allowable benefit under Section 415 of the Internal Revenue Code (Code) is 100 percent of compensation, your monthly pension cannot increase. And, because the monthly benefit isn't increasing, the current (lump sum) value of the benefit is actually decreasing since you are now a year older, your future life expectancy has decreased, and so you are expected to receive that same $10,000 for a shorter period of time. The following illustrates the decreasing value of the pension benefit:

Age	Monthly Pension	Lump Sum Value
62	$10,000	$2,032,600
63	$10,000	$1,981,450
64	$10,000	$1,929,870
65	$10,000	$1,877,680

If you terminated the plan at age 62, rolled over the $2,032,600 to a 401(k) or IRA and earned 5 percent per year, you would have $2,352,989 at age 65. If the plan remained in effect and assets earned the same 5

percent, the plan would have $2,352,989, BUT you would only be entitled to receive $1,877,680. The plan would now be almost $500,000 overfunded and you would have to deal with the ramifications (as illustrated above). Lesson to be learned: If you are at the maximum benefit levels and your benefit is not likely to increase, your benefits may actually begin to decrease.

Required Distribution Considerations

Under current law, required distributions must commence in the year you attain the age of 72. The initial distribution can be delayed until April 1 of the following year. For purposes of simplicity, let us assume that the distribution will be taken during the year of attaining age 72. Consider the following fact pattern:

- You have a defined benefit plan and you are currently age 71.
- Your average compensation is $120,000 and you do not expect this to increase in the future.
- You have accrued the maximum benefit of 100 percent of average compensation, which is $10,000 per month.
- The present value of this benefit is approximately $1,550,000.
- If the plan is in effect on January 1 of the following year, your required distribution will be $120,000.
- Plan assets are $1,600,000.

Given that your compensation will not be increasing, the likelihood of future contributions will be remote, unless your plan becomes underfunded.

Your actuary has come up with the following idea. Terminate the plan and rollover the assets to a 401(k) plan or an IRA. Based on current IRS tables, the required distribution from the 401(k) plan for the following year if you rolled the entire benefit to the 401(k) plan would be about $58,000. So, the defined benefit plan termination would accomplish:

- A reduction in your required distribution of over $60,000.
- Risk of overfunding due to investment returns in the pension plan is eliminated and any investment returns will now inure to your benefit in the 401(k) plan.
- Instead of having a plan that cannot have contributions made to it, you can contribute to an existing or new 401(k), assuming continued compensation at the same or a declining amount

If you left the plan as is, you would have higher required minimum distributions and no future contributions and the risk of overfunding since benefits cannot increase.

Anticipated Change in Demographics

You have had a defined benefit plan in place for several years that has utilized a maximum (100 percent of compensation) formula. Business has been excellent and you have decided to add on a few employees in the next year. These employees are older, well experienced and will be valuable additions to your business. Your actuary has advised that these employees will generate a required contribution of at least 50 percent of their compensation. This could be the time to terminate the existing plan and sit back and reflect on what a success it has been. A similar scenario is that you purchased a business that provides similar services and this entity has several employees that would now have to be covered by your plan (due to controlled group or affiliated service group reasons).

The moral of the story is to be proactive in deciding whether it is time to terminate the plan. Better early, when you are dictating the terms, than too late when you can be subject to unfavorable financial outcomes. ■

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