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Alternatives for Sponsors of Defined Benefit Pension Plans

by Kimberly S. Couch on April 26, 2023

For decades, it was common for employers to maintain employer-funded defined benefit pension plans ("DB Plans" or "Plans") to provide retirement benefits to their employees. In recent years, DB Plans have become increasingly expensive and difficult to administer due to funding, insurance premiums, and government filing requirements. As a result, employers have been freezing or winding up their DB Plans and replacing them with 401(k) plans funded with employer and employee contributions. Recent increases in interest rates, after a long period of historically low rates, make some approaches to trimming or terminating DB Plans newly attractive.

This post summarizes options that may be available to employers that sponsor DB Plans ("Plan Sponsors") to reduce administrative costs and risk factors (de-risking strategies) in connection with their DB Plans, and/or to terminate their DB Plans.

Stay the Course for Funded Plans

If a DB Plan is well-funded despite years of stock market volatility and (until recently) historically low interest rates, a Plan Sponsor may not be required to make DB Plan contributions and may even pay Plan expenses (*e.g.,* attorney, actuarial, recordkeeping, investment adviser, and accountant fees) out of Plan assets. If so, the DB Plan may provide valuable benefits to employees at an extremely low cost. A Plan Sponsor may wish to continue the Plan, and not consider options described in this post.

Important: If some (or all) DB Plan participants are covered under a collective bargaining agreement, a Plan Sponsor may be required to obtain union approval before it takes any of the actions described below with respect to employees covered by the collective bargaining agreement. A Plan Sponsor may take action with respect to non-bargaining unit employees without union approval.

Plan Mergers

If a Plan Sponsor maintains more than one DB Plan, the costs associated with two plans may be reduced through a Plan merger. Following a merger, the Plan Sponsor will pay (i) for a single actuarial valuation and Form 5500 (including audited financial statements) and (ii) to update a single Plan document for tax law changes.[1] In addition, if one of the DB Plans is well funded and the other is not, a DB Plan merger may eliminate or reduce the Plan Sponsor's obligation to pay variable rate PBGC premiums for the underfunded DB Plan.[2]

A Plan Sponsor is required to file Form 5310-A, Notice of Plan Merger or Consolidation, with respect to each DB Plan involved in a Plan merger at least 30 days before the merger effective date. Each participant in the merged DB Plan must receive a benefit immediately after the merger that is equal to or greater than the benefit he or she would have been entitled to receive immediately before the merger, with pre- and post-merger benefit values determined on a Plan termination basis. If one or both of the DB Plans is underfunded, this requirement may not be satisfied post-merger. Accordingly, the Plan actuary must certify that, in the event of a spinoff or termination of the merged DB Plan within five years following the merger, the actuary has or can create a schedule of Plan assets that will properly allocate benefits to participants so that each participant will receive the same benefit that he or she was entitled to receive (determined on a Plan termination basis) prior to the merger.

Freezing Plan Participation and Benefit Accruals

Two simple de-risking strategies to reduce the cost of funding benefits under a DB Plan include (i) closing the Plan to new participants (a soft freeze) and/or (ii) freezing benefit accruals for all participants (a hard freeze). As a rule, these de-risking strategies require votes by a Plan Sponsor's Board of Directors. In addition, affected individuals (*e.g.*, participants, alternate payees entitled to benefits under a qualified domestic relations order, and union representatives) must be notified of the freeze at least 45 days before the effective date of a soft and/or hard freeze.

A frozen DB Plan is treated as an ongoing Plan, even if the Plan Sponsor adopts a hard freeze. Accordingly, a Plan Sponsor must make contributions to fund benefits earned as of the freeze date, update Plan documents for changes in the tax laws, pay premiums to the Pension Benefit Guaranty Corporation ("PBGC") to insure Plan benefits, pay for

[1] Legally, a Plan Sponsor may distribute only a single summary plan description ("SPD"). However, if the pre-merger DB Plans have significantly different eligibility requirements, benefit formulas, retirement dates, and distribution options, it may be less confusing for participants if separate SPDs are prepared for the merged Plan.

[2] All Plan Sponsors of single-employer DB Plans pay a PBGC flat rate premium equal to $96 per-participant for 2023. In addition, Plan Sponsors of underfunded single-employer DB Plans pay an additional variable rate premium equal to $52 per $1,000 of unfunded vested benefits capped at $652 times the number of DB Plan participants for 2023.

actuarial valuations, file Form 5500s, and provide participants with Plan updates, benefit statements, and required notices.

Additional De-Risking Strategies: Lump Sum Windows and Annuity Purchases

A Plan Sponsor that is not ready to terminate its DB Plan may reduce the number of Plan participants and their associated costs by (i) offering a lump sum window to participants who have terminated employment and/or (ii) purchasing guaranteed contracts from an insurance company to provide benefits to retired participants.

Lump Sum Window. A Plan Sponsor may amend its DB Plan to offer a temporary window during which participants who have terminated employment but are not in pay status may elect lump sum cash distributions of their Plan benefits.[3] A lump sum window may be offered in conjunction with an early retirement incentive program but may not be offered to participants who remain employed with the Plan Sponsor. The window program must be offered to a group of participants that does not discriminate in favor of highly compensated employees, as determined by the Plan actuary. The historically higher interest rates in 2023 provide Plan Sponsors with a unique opportunity to offer a lump sum window under their DB Plans because higher interest rates produce lower lump sum values.

Guaranteed Annuity Purchases. A DB Plan Sponsor also may seek annuity bids from insurance companies to purchase guaranteed annuity contracts to provide benefits to retired and terminated vested participants. It appears that insurance companies are willing to make competitive bids in 2023 due to the higher interest rates. The selection of an insurance company to provide guaranteed annuity contracts is subject to the fiduciary requirements of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and must be prudent.

Both de-risking strategies just described reduce the number of DB Plan participants, which should reduce a Plan Sponsor's costs associated with recordkeeping, preparation of benefit statements, and PBGC premiums. In addition, these strategies should reduce a Plan Sponsor's costs associated with a future DB Plan termination, which is described below.

[3] IRS regulations provide that lump sums may be offered to retired participants and beneficiaries in pay status upon Plan termination. Although the IRS pulled guidance prohibiting ongoing Plans from offering this option (see IRS Notice 2015-49 and IRS Notice 2019-18), the conservative approach is to offer a lump sum option to retirees in pay status only upon Plan termination.

Plan Termination

If a DB Plan is sufficiently funded to satisfy all benefit obligations to Plan participants, a Plan Sponsor may terminate its DB Plan in a standard Plan termination. A DB Plan termination is complex and requires numerous actions, including multiple participant notices and government filings, which are briefly described below.

Board Votes. To commence Plan termination proceedings, a Plan Sponsor's Board of Directors must vote to terminate the Plan as of a proposed termination date.[4] The proposed termination date is used for purposes of providing notices to participants, the Internal Revenue Service ("IRS"), and the PBGC of the employer's intent to terminate the Plan.

Plan Amendment. The Plan document must be amended to reflect the tax laws in effect as of the date of Plan termination.

Notice to Participants of Intent to Terminate the Plan. The Plan Administrator[5] must provide each participant, alternate payee, and beneficiary of a deceased participant with written notice of the Plan termination at least 60 days but no more than 90 days before the Plan's proposed termination date.

Notice to the PBGC of Intent to Terminate Plan. The Plan Administrator must file a notice of the Plan termination with the PBGC using PBGC Form 500, Standard Termination Notice, no later than 180 days after the proposed termination date. The information included on Form 500 must establish that DB Plan assets are sufficient to pay all benefit obligations as of the proposed date for distributing assets upon Plan termination. If Plan assets will not be sufficient, the Plan Sponsor must agree in writing to contribute the amount necessary to make Plan assets sufficient before benefits are distributed upon Plan termination.

The PBGC will issue a notice of noncompliance to the Plan Administrator within 60 days after receipt of Form 500 if it determines that the assets of the Plan will not be sufficient to provide all benefits upon Plan termination. Absent receipt of a PBGC notice, the Plan Sponsor must distribute Plan assets (including annuity contracts) to participants within 180 days after the expiration of the 60-day PBGC review period. If the Plan Sponsor applies for an IRS determination letter on or before the date the Form 500 is filed with

[4] If the Board has not yet voted to freeze benefit accruals under the DB Plan, that directive may be included with the Plan termination vote, and information about the freeze may be combined with the notice of intent to terminate.

[5] The Plan Administrator may be the Plan Sponsor, or a committee or person designated by the Plan Sponsor to administer the Plan.

the PBGC, however, the distribution deadline will be extended automatically until 120 days after the Plan Sponsor's receipt of the IRS letter.

Notice to Participants of Plan Benefits. A notice must be issued to each participant, alternate payee, and beneficiary of a deceased participant under the Plan describing the amount and form of his or her benefit as of the proposed termination date and how the benefit was calculated no later than the date the Form 500 is filed with the PBGC.[6] The notice must identify the insurance carrier(s) from whom guaranteed annuity contracts will be purchased. If the insurance carrier(s) are not known or change before Form 500 is filed with the PBGC, the insurance carrier(s) must be identified at least 45 days before DB Plan assets are distributed upon Plan termination.

Application for Determination Letter with the IRS. A Plan Sponsor may file an electronic application using Form 5310, Application for Determination upon Termination, to request an IRS determination letter on the tax-qualified status of the DB Plan upon Plan termination. Although this filing is optional, an IRS letter ensures that actions taken to terminate the Plan, including Plan amendments, have not adversely affected the DB Plan's tax-exempt status. Notice of the IRS application must be provided to interested parties (*e.g.*, participants, alternate payees, beneficiaries of deceased participants, and union representatives) at least 10 days and no more than 24 days before Form 5310 is filed with the IRS.

There is no designated IRS review period for a determination letter on the Plan termination. Accordingly, application should be made to the IRS as soon as possible following distribution of the notice of intent to terminate to participants, and prior to the filing of Form 500 with the PBGC to (i) expedite the determination letter process and (ii) ensure the Plan Sponsor receives an automatic extension of the PBGC distribution deadline.

Benefit Election Forms. After the Plan Sponsor receives a favorable IRS determination letter, benefit election packages must be distributed to participants describing their rights to automatic forms of payment (*e.g.*, single life annuity for an unmarried participant) and optional forms of payment available upon Plan termination, including the option to roll over lump sum distributions (if available) into eligible retirement plans and IRAs.

Annuity Bids. A Plan Sponsor must purchase guaranteed annuity contracts from an insurance company to provide benefits to participants and beneficiaries who do not elect lump sum distributions of their benefits or were not offered a lump sum option. As

[6] The content of the notice varies depending on whether the participant or other affected party is in pay status.

described above, the selection of an insurance company to provide guaranteed annuity contracts is subject to the fiduciary requirements of ERISA.

Distributions. After the PBGC 60-day review period has ended and the Plan Sponsor receives a favorable IRS determination letter, the Plan may distribute Plan assets (including annuity contracts, lump sum distributions, and direct rollovers) to participants and beneficiaries. The assets should be distributed as soon as administratively feasible after government approvals have been obtained.

Missing Participants. If participants and beneficiaries are missing (they cannot be located after the Plan Administrator completes a diligent search) or are unresponsive (they have been located but do not timely return their benefit election forms), the Plan Administrator may purchase guaranteed annuity contracts on their behalf as described above or transfer their benefits to the PBGC under the PBGC's Missing Participant Program. Benefits must be transferred to the PBGC by filing PBGC MP-100 on or before the date Form 501 (described below) is filed with the PBGC.

Reversions. If surplus assets remain after all benefit liabilities have been satisfied (including payment of permissible Plan expenses), the surplus assets may revert to the Plan Sponsor, subject to either a 20% or 50% excise tax.[7]

Post-Termination Filings

PBGC Form 501. The Plan Administrator must file PBGC Form 501, Post-Distribution Certification, with the PBGC within 30 days after the final distribution of benefits from the terminated Plan. The Plan Sponsor must pay prorated PBGC premiums for the final short plan year that includes final distributions.

Form 5500. A final Form 5500 must be filed within seven months after the end of the month in which all assets have been paid out of the DB Plan.

Forms 1099-R. The Trustee of the Plan must prepare a Form 1099-R for each participant and beneficiary who receives a distribution from the Plan. The Form 1099-R must be issued by January 31 of the year following the year of the distribution and filed with the IRS by February 28 of the year following the year of the distribution.

[7] The 50% excise tax on the reversion of surplus DB Plan assets is reduced to 20% if at least 25% of the surplus assets are transferred to a qualified replacement plan maintained by the Plan Sponsor. If the Plan Sponsor transfers 100% of the surplus to a qualified replacement plan, no excise tax will be imposed.

Please contact a member of our Employee Benefits & Executive Compensation Group if you have any questions regarding maintaining or freezing benefit accruals, plan mergers, de-risking strategies, or plan termination with respect to a DB Plan.

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