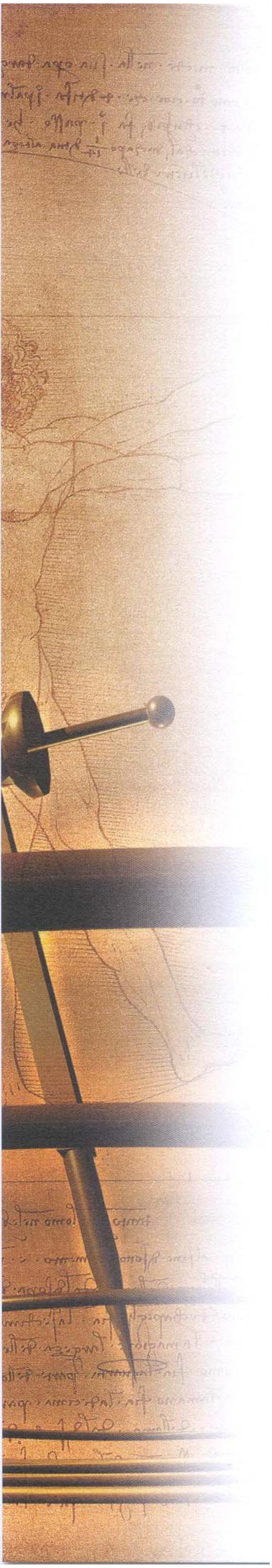

Volume 7, No. 4 – Q4 2009

Nolan Financial Report

PENSION CLOSEOUT OPPORTUNITIES

A Disciplined Approach

The decision to terminate a defined benefit pension plan can be a difficult one for plan sponsors and will depend on a careful consideration of the cost of continuing the plan, the plan's overall impact on the company, and the potential impact on employee relations by terminating the plan.

<u>Cost</u>

The Pension Protection Act of 2006 (PPA '06) and its new defined benefit pension plan funding requirements has, for many companies, significantly increased the cost of maintaining a defined benefit pension plan.

PPA '06 Section 112(a) almost completely replaced the prior rules governing the funding of single-employer, defined benefit pension plans with a new standard keyed solely to the plan's funded status. The general principle is that a plan's required contribution should equal the present value of benefits earned by participants during the current year, plus the amount necessary to amortize any funding shortfall over no longer than seven years. In the case of severely underfunded (i.e., at-risk) plans, special rules increase the funding obligation. The PPA '06 funding rules were generally effective beginning in 2008. However, the PPA '06 also extended --for 2006 and 2007--funding relief enacted in 2004.

PPA '06 Section 113(a)(1)(B) imposes a variety of new benefit limits on single-employer plans whose funded status falls below specific levels. Poorly funded plans may be subjected to restrictions on benefit accruals, benefit increases or accelerated payment of benefits, depending on the degree of underfunding.

Impact on Company

For many companies, maintaining a pension plan (or deciding to terminate one) will have a significant effect on how the company conducts its operations. In addition to the PPA '06 funding rules discussed above, which may significantly reduced the company's liquidity in the short-run, an underfunded plan may trigger PPA '06 rules that put certain limits on executive compensation. <u>See Nolan Financial Report of July 2007.</u> Specifically, Section 116 restricts an employer's ability to set aside assets in a trust or other arrangement to fund nonqualified deferred compensation plans for its top five executive officers during (1) the period that the employer's defined benefit plan is deemed at risk, (2) the period that the employer is in bankruptcy and (3) the 12-month period beginning six months before the termination of an underfunded plan. If amounts are set-aside in violation of these rules, or subject to provisions that they will be set-aside in these circumstances, the executive will owe tax on them. This tax will not apply to assets set-aside before the restriction period.

Any tax gross-up payment provided by the employer to defray an individual's tax liability, under PPA '06 Section 116, is deemed deferred compensation subject to a 20% additional tax under Sec. 409A(b)(5)(A). In addition, an employer cannot deduct these gross-up amounts, under Sec. 409A (b) (3) (C) (iii). These rules apply to transfers made after August 17, 2006.

Employee Relations

In addition to the legal aspects discussed above, a plan sponsor should consider what impact a plan termination would have on employee and/or labor relations. In many instances, a company's pension plan may be one of the main reasons why many tenured executives made the decision to stay with the company over the course of their careers. A defined benefit pension plan may also be an effective tool for recruiting new employees, and in some industries, it may even be a ubiquitous method for attracting new talent.






So, the decision conundrum that the CEO and other decision makers must address is the continued escalating costs of maintaining a Defined Benefit Plan in a market that lost approximately 30% of its value over the last year coupled with the requirement that the company maintain a certain percentage of funding or face other consequences that might impact their company's nonqualified plans and the potential for adverse employee relations feedback.

Over the last few years, many CEO's and Compensation Committees have addressed this same challenge and decided to freeze the participation and allow vesting to continue until all current participants have reached full vesting. Others have chosen to terminate the plan. Oftentimes these different decisions are made based upon the level of funding required to terminate the plan.

How Does A Company Move forward

In March 1995, the U.S. Department of Labor (DOL) issued Interpretive Bulletin 95-1 (IB 95-1), which established guidelines to help plan fiduciaries select an insurer as an annuity provider for purposes of a pension benefit distribution. IB 95-1 dictates that plan fiduciaries need to conduct an objective, thorough, and analytical review in determining the "safest available annuity" for retirement plan participants. According to the bulletin, reliance solely on ratings provided by insurance rating services is not sufficient to meet this requirement. The bulletin indicates that plan fiduciaries should consider a number of other factors including, among other things:

- The quality and diversification of the annuity provider's investment portfolio
- The size of the insurer relative to the proposed contract
- The level of the insurer's capital and surplus
- The insurer's lines of business and other indications of the insurer's exposure to liability
- The structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts
- The availability of additional protection through state guaranty associations and the extent of their guarantees

What is a Terminal Funded Annuity

When a company makes the decision to terminate its defined benefit pension plan, it still maintains the same benefit obligation. Perhaps they can select the Terminal Funded Annuity as the substitute vehicle of choice. This type of annuity is also known as a Single Premium Group annuity Contract (SPGAC). We feel that the recent passage of the legislation mentioned above, has prompted plan sponsor interest in SPGAC's. These contracts provide for a number of annuity purchases at the same time and still reflect all of the pension plan's provisions for areas like early retirement, death benefits and optional forms of payment. The SPGAC will cover retired employees who are already receiving a benefit as well as employees who are still working whether they are partially or fully vested.

The typical purchasers of SPGAC annuities are corporations, municipalities, hospitals or churches that now provide a qualified 401(a) defined benefit pension plan. The plan sponsor, who is the ultimate customer and decision maker, makes the decision whether or not to terminate the plan in consultation with the plan actuary. Fiduciary compliance is paramount to the plan sponsor. In the late 1990's, the government established important guidelines indicating that the plan sponsor must purchase the annuities from the safest available annuity provider.

The Nolan Protocol

In our role as an advisor, Nolan Financial works closely with the plan sponsor, the plan sponsor's legal counsel, and the plan's actuary to ensure that all U.S. Department of Labor (DOL) guidelines are followed in order to determine the "safest available annuity" for retirement plan

participants. These guidelines are outlined in the DOL's *Interpretive Bulletin 95-1*, which lists a number of factors that must be considered in the selection process. Nolan Financial coordinates the solicitation of annuity bids from insurers and serves as the primary contact for the insurance companies throughout the bid process.

Upon receipt of initial preliminary bids, Nolan Financial thoroughly reviews the bids to confirm that all of the responding carriers have based their bids on the correct pricing assumptions as specified in the provided quote specifications. Nolan Financial then prepares an extensive and objective analysis of the insurance companies and their respective annuity proposals to aid the client in its decision. On the date that final bids are submitted by the insurance companies, Nolan Financial assesses the bids to determine which carriers qualify as finalists and utilizes a competitive "auction" process to ensure that the client receives the best available price. During the "auction" process, negotiations are conducted on an individual basis with each of the leading carriers in an effort to drive the annuity price down to the lowest possible level before a final decision is made by the client and its legal counsel.

It is not uncommon for companies that are freezing or terminating their defined benefit pension plan to consider implementing a nonqualified plan for their senior executives and increasing or implementing an employer match in their qualified 401(k) plan. This decision is much more than just a financial one; it has tremendous employee relations implications and must be handled accordingly. However, it is important to keep in mind that increasing 401(k) plan matching formulas may require immediate cash outlays rather than funding obligations that might be payable over a seven-year period.

When this company chose to engage Nolan Financial, it also engaged our disciplined process. This process, combined with Nolan Financial's independence, allows us to shop the entire market with the only goal being the most cost efficient and effective solution for the client.

IRS Oversight

Overriding all of these protocols is the Internal Revenue Service (IRS). Upon the decision to terminate a pension plan, the IRS wants the plan sponsor and their company to reaffirm that the reason for plan termination is legitimate. Generally, an employer's decision to terminate will not be questioned if the plan has been in existence for 10 years or more. Each termination is generally viewed by the IRS based on its specific facts and circumstances. Typically, the reasons for plan termination are the adoption of a new plan, business hardship, mergers, and business liquidations among others. If the IRS does not deem the termination valid, then they may enact a retroactive plan disqualification. Unfortunately, this could have significant adverse tax consequences for the employees and the plan sponsor. This is another reason why competent pension counsel and a strict protocol are important. Usually the smart employer will request an advance determination letter from the IRS to verify the plan's continued qualification status. This is a smart hedge against uncovering problems and may reduce the chances of an IRS audit. Further, such a determination may be required by a purchaser in the context of a future merger or acquisition. In fact, often times filing the letter may enable a plan to retroactively correct certain problems uncovered by the IRS during its determination letter process.

Summary

While the process and protocols may sound onerous, it is nonetheless a very orderly and well-understood process for those whose protocols have been tested and reviewed by the IRS and various plan counsels.

It is a process best left to those who understand the processes and have the protocols that will allow the employer to achieve their goal.

We also want to recognize the contributions made by **David Levine**, a Benefits Partner and **Michael Kreps**, a Benefits Associate at the Groom Law Firm in Washington, DC. Their edits and counsel were most appreciated.

In the meantime, if you have any questions or concerns about how your company may be impacted, please contact:

Michael E. Nolan
President and CEO
Nolan Financial
Phone: 301-907-9500
E Mail – NolanM@Nolanfinancial.com

William A. Craig
Nolan Financial
V.P. Business Development
Phone: 866-810-6442
Email: CraigW@Nolanfinancial.com

Michael Nolan is a registered representative of Lincoln Financial Advisors Corp
.
Securities offered through Lincoln Financial Advisors Corp., a broker/dealer. Insurance offered through Lincoln affiliates and other fine companies.
Lincoln Financial Advisors does not offer legal or tax advice. Lincoln representatives may not act in a fiduciary capacity on ERISA plans. CRN200908-2033076

NOLAN FINANCIAL