Revisiting Defined Benefit Lump Sums Now in 2020

May 2020

The COVID-19 global pandemic has created significant economic difficulties for both plan sponsors and participants. Many participants, in looking for sources of cash to address short-term financial needs, are considering turning to their 401(k), 403(b) or IRA – potentially putting these participants in the position of "selling at the bottom" and missing out on market upswings.

Over the last several years, many sponsors of defined benefit (DB) plans have offered temporary lump sum windows to terminated vested participants or sent reminder mailings to participants who have such an option, but haven't taken advantage of it. These actions have often taken place as interest rates have fallen from one year to the next, creating a financially beneficial situation for the plan sponsor. With rates tumbling during 2020, these conditions are present again. Combine this with the potential attractiveness of access to DB money for some participants, and we believe it's worth sponsors consider lump sum offers in 2020.

WHY 2020?

ERISA covered plan lump sums are typically paid based on corporate bond interest rates from a month in the prior year. While the corporate bond rate market has been extremely volatile, as of the end of April, rates are down approximately 50 basis points from the beginning of the year. Assuming this holds, then for a typical pension plan, being able to pay lump sums at last year's rates means paying lump sums at a 7% - 10% discount relative to their current liability. For plan sponsors who use international accounting, this may translate to a direct benefit on their P&L statement in 2020. And for underfunded plans, this can reduce the overall dollar amount of underfunding.

Sponsors also temporarily have more freedom to implement windows. Ordinarily, plans must be at least 80% funded (as measured using IRS-mandated assumptions) after amending the plan to allow a window. The CARES Act – signed into law in March to provide financial and business relief from the effects of COVID-19 – allows plan sponsors to proceed with windows so long as they were 80% funded in the last year ending before January 1, 2020 (i.e. the January 1 – December 31, 2019 plan year for calendar year plans).

POTENTIAL AREAS OF ACTION

We see two potential areas of action for plan sponsors in 2020:

1

Lump sums for terminated vested

For plan sponsors considering a first- or second-round temporary lump sum offer to terminated vested participants – or considering reminder mailings to participants who already have a lump sum available -- 2020 may be the year to act. Beyond the interest rate environment described above, there's also the potential for slightly higher take rates due to greater participant interest in access to the DB money.

2

Lump sums for actives

The SECURE Act, signed into law in December 2019, lowered the in-service distribution age for DB plans to 59-1/2. In-service distribution provisions for DB plans remain completely optional. But in the current environment, it may be worth considering adding one – either temporarily (via a window) or permanently.

In addition, it's worth keeping in mind that the in-service distribution option was originally added for DB plans as a way to encourage "phased retirement", where a participant would reduce their work schedule and make up the income shortfall by beginning their pension benefit. Providing such an option could help manage temporary workforce considerations created by COVID-19 and including a lump sum option for such participants could add additional, valued flexibility.

Lump sums for actives have many considerations. Depending on plan design and actuarial assumptions, they can potentially increase the plan's liability, so it's worth consulting with an actuary to better understand the implications before proceeding.

When it comes to lump sums – whether for actives or terminated vesteds – there are also potentially some additional tax benefits a participant could claim if they were directly impacted by COVID-19. These benefits may include avoiding early payment penalties, spreading the tax on the lump sum over three years, and the ability to repay the money to another qualified plan or IRA over the next three years. Not all participants who might elect a lump sum would qualify for special COVID-19 tax treatment. But they may appreciate access to the money in these difficult times, particularly since alternative sources (i.e. an IRA or 401(k) balance) would require "selling at the bottom" and potentially missing some of the benefits of a market rebound.

Next Steps

As COVID-19 has unfolded rapidly, companies have been reacting in different ways. While there may be urgent business tasks to consider in the short-term, it's worth keeping in mind that the option for a lump sum in 2020 may reap potential benefits —both to the business as well as to participants who have been impacted by this global pandemic.

For More Information

For more information on this topic, please contact your Fidelity Relationship Manager or contact us directly.

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