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MARKET VOLATILITY PLAYS HAVOC WITH DEFINED BENEFIT PLAN FUNDING

All financial professionals with Defined Benefit Plan clients need to understand how market volatility affects funding of these plans. Given that the market made big gains in 2019 and now we are seeing losses in 2020, it is important to explain to clients why their funding is so dramatic year to year in order to help them with cash and tax planning. A proactive approach is required now, more than ever.

In general, Defined Benefit plans (DB) work off a predetermined future benefit to calculate the current year's tax-deductible contribution. A pension actuary is required to determine annually how much can be contributed to meet the plan's minimum funding requirements. In order to calculate the plan's contribution, the actuary follows assumptions detailed in the plan document to answer these questions. How much do we need at retirement to provide this particular benefit? How long do we have to fund to get to this amount? How much interest is the money going to earn throughout the years? And, there are other factors involved like life expectancy, post-retirement interest rates and type of benefit payable at retirement.

The pre-retirement interest rate is the assumption that causes problems in a volatile market. In the past, if you wanted a bigger contribution, an actuary would assume a lower interest rate. If you earn less on the money, you need to contribute more. Now the current regulations require an actuary to use an interest rate within a range, usually 5%.

We have many clients whose defined benefit assets earned upwards of 20% in 2019. This means they may have met their funding for 2019 without having to contribute for that year. These zero or small contributions have hurt tax planning, as many assumed, they would be looking at amounts similar to prior years. Clients and their financial advisors need to understand that while this may not allow tax deductions, they are still ahead because they get "free" funding towards their benefits at retirement.

Now in 2020, we are seeing a major correction as the market reacts to world events. Many of the prior gains are now losses. This will help with overfunded DB plans, but could also double contributions in 2020 for others. People who had a $200,000 normal contribution may have zero in 2019 and then $400,000 in 2020. The Pension Protection Act of 2006 provides for a seven-year amortization of the losses, so those clients affected by the downside of the market do not have to make up the total loss in one year. For plan sponsors who wish to decrease their 2020 required contribution, an amendment must be completed and participant notice is distributed before any participant works the 1000 hours benefit accrual requirement. The hour requirement may be different in your plan, so check the official plan document.

A large loss in the plan's assets will also trigger distribution restrictions should the plan's funding status fall below 80%. The plan will be prohibited from providing **full** lump sum distributions to any participant upon leaving the company. Any lump sum distribution is limited to 50% of its current value. These restrictions will remain in effect until the funding percentage increases to a level of 80% or more. There are additional restrictions should the funding status fall below 60%.

This is the opportune time to review all overfunded DB plans. If the owners have accrued their maximum benefits and the excess assets are eliminated or greatly reduced, this may be the time to terminate the plan. The excess, if any, can be transferred into a profit sharing or 401(k) plan and allocated to participants over the next seven years while avoiding the 50% excise tax.

Under the CARES Act, a plan sponsors' contribution due during 2020 is not required to be made until January 1, 2021, including quarterly contributions. The minimum amount will be increased by the plan's rate of interest for the interim period. Despite this relief, clients should consider freezing 2020 benefit accruals in the defined benefit plan or, for defined contribution plans with hard-wired contributions, adding last day employment requirements, to prevent a possible overwhelming funding obligation.

Finally, the remedial amendment period for restating defined benefit plans, which was due to end on April 30, 2020, has been extended to July 31, 2020.

BOTTOM LINE: Contact your Defined Benefit clients and see how things are going. Review their trust accounts for major gains or losses and see how these may affect 2019 and 2020 funding. A proactive review is always a great value to clients and should be done given the current market volatility. As always, we are here to help.