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Defined Benefit Pension Plans: In-Service Distributions

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Even though 401(k) plans have become the dominant employer-provided retirement vehicle, about 31 million participants continue to be covered under defined benefit pension plans.

While most participant benefits under single-employer defined benefit plans are ultimately protected by the Pension Benefit Guaranty Corporation, primary responsibility for funding the plan rests with the sponsoring employer and its controlled group. Many pension funds are well-funded — for example, for the Fortune 1000 companies that sponsor defined benefit pension plans, the plans' aggregate funded ratio reached 100% as of the end of 2023. However, funding ratios can be volatile. Investment returns might be negative. Interest rates might decline. Improvements in life expectancy might result in the plan paying annuity benefits for longer than predicted under the plan's actuarial assumptions. The potential volatility has caused many plan sponsors to consider "de-risking" the plan.

Pension plan "de-risking" includes actions taken to currently settle pension plan obligations rather than having those benefit obligations paid by the plan at a later commencement date and/or in annuity form over the participant's (or the participant's and beneficiary's) lifetime. Typical "de-risking" options include (1) annuity contract purchases on behalf of retired participants who are receiving monthly annuity benefits (thereby transferring future payment responsibility and risk from the plan/employer to an insurance carrier), and (2) temporary lump sum payment election windows, generally made available to former employees who have not yet commenced their benefit (resulting in the current settlement of the plan's benefit obligation with respect to a participant who accepts the lump sum offer in lieu of future annuity benefits).

In addition, some plan sponsors with an interest in "de-risking" have expressed interest in offering lump sum benefits to active employees, especially where the pension plan is "frozen" such that participants have a vested accrued benefit but are not accruing further benefits under the plan. (A plan might permit in-service distributions without offering a lump sum benefit option, but the availability of a lump sum option is important if "de-risking" is part of the strategy.) The legal terrain is more complicated with respect to active employee distributions since the pension rules generally permit distribution to be made only upon retirement or termination of service. Even so, the pension rules allow a defined benefit pension plan to permit in-service distributions to participants who have attained either 59½ years of age or the plan's normal retirement age. This is an optional, not required, provision. A plan is not required to permit in-service distributions, but it can permit in-service distributions to participants who have attained age 59½ (or any later age specified in the plan).

Various issues must be considered when making a lump sum distribution available to active employees aged 59 and a half or older.

1. *Considerations Beyond "De-Risking."* As discussed, many employers consider in-service distribution options in the context of a "de-risking" strategy. An employer should also consider in-service distribution options in terms of employee retention considerations. For example, an in-service distribution feature might permit an employer to retain (either on a part-time or full-time basis) older, skilled workers who otherwise might retire from active employment to receive payment of an available pension lump sum or begin receiving their monthly pension benefits.
2. *In-Service Distribution Options Must Include Annuity Payment Forms.* Although an employer might be motivated by "de-risking" considerations that are best satisfied if the participant elects a lump sum form of payment, the plan cannot force a lump sum distribution and cannot provide a lump sum distribution as the only in-service payment option. Instead, the plan must offer the participant both the lump sum option and certain annuity forms of distribution that commence during continued employment at the same time as the lump sum payment. At a minimum, an immediate single life annuity (for unmarried participants) and a Qualified Joint and Survivor Annuity and Qualified Optional Survivor Annuity (for married participants) must be made available.
3. *Benefit Calculation Considerations.* A sponsor who is considering the addition of an age 59½ in-service distribution option should consult with its advisor regarding the calculation of benefits for any participant who elects distribution commencing prior to termination of employment.
    - In many pension plans, participants who terminate employment and commence benefits prior to the plan's normal retirement age (early retirees) receive a subsidized benefit that is actuarially more valuable than the plan's normal retirement benefit. For example, the plan might provide that the benefit for an early retiree is the plan's normal retirement benefit without a reduction for early commencement or the plan's normal retirement benefit with an early commencement reduction that is less than the plan's actual expected cost for early benefit commencement. These are referred to as subsidized benefits because the actuarial value of the early retirement benefit is greater than the value of the plan's normal retirement benefit.
    - IRS rules generally permit subsidized early retirement benefits even though the actuarial value of the benefit at a younger age is greater than the actuarial value of the benefit at normal retirement age. However, for an in-service distribution provision, the participant has not retired or terminated service, and there is an open legal question of whether subsidized early retirement benefits can or should be made available to a participant who elects in-service distribution. The alternative is to draft the plan amendment so that the in-service distribution options are calculated as the actuarial equivalent of the plan's normal retirement benefit without consideration of any early retirement or early commencement subsidies.
    - There might be multiple aspects to the early retirement subsidy issue beyond the unanswered legal question. For example, including the value of subsidies in the in-service distribution options might make the in-service distribution program very popular, particularly in the case of a "frozen" plan, which in turn might have cost implications to the plan sponsor if a meaningful number of participants both continue in employment and elect payment under the subsidized (more expensive) plan options.
    - On the side of not including subsidies as part of the in-service distribution options, the argument can be made that subsidizing the participant's benefit is not appropriate

because, unlike a traditional early retirement benefit, the participant is not required to relinquish his or her employment to receive or commence the pension benefit. However, if subsidies are not offered as part of the in-service distribution options, the pension election materials should clearly describe the situations in which the benefit that is made available for in-service distribution differs from the benefit to which the participant might be entitled at the same age if the participant had terminated employment and then commenced his or her benefit. The ERISA landscape is full of cases alleging breach of duty where plan fiduciaries are alleged to have withheld or not properly communicated information that might be relevant to a participant's benefit elections.

4. *In-Service Distribution Options may be a Protected Plan Feature*. Active employees aged 59 and a half or older may be included as part of a limited-term (window) lump sum offering. Active employee in-service distribution provisions can also be added as a permanent plan feature, just like other optional forms of distribution. Once added to the plan as a permanent feature, IRS rules generally prohibit any subsequent action to eliminate the in-service distribution feature for benefits that have already accrued. Although the Internal Revenue Service generally respects limited-term (window) benefit offerings, the IRS has cautioned that a pattern of repeatedly opening similar window programs might be viewed as a permanent (and protected) plan feature that must be made available on an ongoing basis.
5. *Plan Funding Considerations*. A lump sum distribution feature (including lump sums offered to active employees on or after attainment of age 59½) works best for reasonably well-funded plans. If plan funding falls below certain thresholds, lump sum distributions might be prohibited or limited, either for all participants or for highly compensated participants. Although this is not an issue for most plans, an employer must understand the potential application of these rules when considering expanded lump sum distribution options, including for active participants. In addition, consideration should be given to the impact that accelerated distributions may have on the employer's expected required minimum contributions in future years.

Whether or not to add an in-service distribution provision to a defined benefit pension plan requires careful consideration of a variety of factors. When properly implemented, a pension in-service distribution provision for employees age 59½ or older can be beneficial both to the employer and the employee.

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