Workshop 15
Benefit Freezes and Their Aftermath

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What’s a Freeze?

• Soft Freeze
  • Service after the freeze date is not recognized
  • Benefits may be increased for compensation and cost of living increases

• Partial Freeze
  • Certain classes of employees do not accrue additional benefits, e.g.,
    employees hired after a particular date are excluded from the plan or
    employees with an odd last digit of their social security numbers will not
    accrue additional benefits.
  • Participants, other than the freeze class, continue to accrue benefits

• Hard Freeze
  • No one accrues additional benefits
  • No new entrants

Effective Date of Freeze

• Non-Title I Plans
  • Plans that cover the sole owner and spouse or,
    Plans that cover partners and spouses
  • §204(h) notice is not required. Freeze may be
    effective on the date the plan is amended.
  • Freeze date cannot be retroactive
Effective Date of Freeze
• Title I Plans-Plans other than non-Title I plans
  • Small/Large Plan participant count is as of the freeze date
  • Small plans (fewer than 100 participants)
    • Fifteen days advance notice of freeze effective date is required
  • Large plans (plans other than small plans)
    • Forty-five days advance notice of freeze effective date is required
• Execution of amendment must be made by the freeze date.
• Effective date of freeze is no earlier than the date stipulated in notice or if later, 15/45 days after affected employees are notified

ERISA §204(h) Notice
• Title I plans only
• Each affected participant must be notified of a significant reduction in the rate of future accruals or of a significant reduction in an early retirement benefit or retirement type subsidy
• What is a significant reduction?
  • Standard is reasonable expectations of participants
• What should be included in the Notice?
  • All information on the benefit formula as accrued plus information on the effect of the anticipated reduction
  • Such notice should clearly identify future benefits are being reduced
  • Should include contact information for questions

Example
• Plan is amended from a traditional defined benefit plan with a 1% of pay accrual to a cash balance account plan where the pay credit is 10% of pay.
  • The actuary determines the value of additional accruals under the cash balance account plan will be less for employees over the age of 50
  • The oldest participant in the plan is 40 years old.
• Does this amendment require a §204(h) notice?
  • Yes
What Happens if §204(h) Notice is not Provided or is Defective?

• Future benefits are unaffected by the amendment
• Excise taxes under IRC §4980F
  • Penalty of $100 per day per participant may be assessed
  • If the entity subject to liability for tax exercised reasonable diligence to meet the requirements, the maximum penalty shall not exceed $500,000 otherwise, no limit.
• Example- No notice is given in a plan that covers 10 participants. After a year the excise tax is $10 x $100 x 365 = $365,000

Woodwork People

• If not all participants are provided a §204(h) notice then the amendment is not effective
• However, to avoid the penalties, we have drafted the resolutions and amendment so that the freeze date is no earlier than 15/45 days after affected participants are notified

Actuarial Increases

• An actuarial increase is not a benefit accrual
• Thus, a plan in which the only increases are actuarial might be a frozen plan
• If the plan provides for suspension of benefits AND if notice is given timely, then the plan is not required to provide an actuarial increase after Normal Retirement Age and prior to the Required Beginning Date (RBD) age 70½ (72).
• Heinz decision §411(d)(6) violation if the plan is amended to provide suspension of benefit provisions for prior benefit accruals however future accruals may provide for suspension of benefits.
• After the Required Beginning Date 70½ (72), all plans must provide for an actuarial increase for the period after RBD through the date benefits commence
• Alternatively, the plan may start benefit payments in lieu of an actuarial increase
Vesting (IRC §411)

- Fully vesting participants is not necessarily required when plan benefits are frozen.
- Full vesting is required upon a termination of the plan, to the extent funded.
- Full vesting is required upon a partial termination of the plan, to the extent funded.
- Treasury regulation §1.411(d)-2(b) concludes a partial termination has occurred if a potential reversion is created or increased on account of the freeze.

Top Heavy Minimum Benefits (IRC §416)

- Service after the freeze date is ignored for top heavy minimum benefits.
- Compensation for top heavy minimum benefits is based on service that is recognized for top heavy benefit accruals. Therefore, if service is excluded after the freeze date so is compensation.
- Result is top heavy minimum benefits are hard frozen when the plan is hard frozen. Regulations have not been updated to reflect the changes in law.
- Benefits are included to determine if this plan and other plans in a required aggregation group are Top Heavy.

Top Heavy Minimum Benefits (IRC §416)

- Top Heavy benefits are frozen if no Key Employee benefits during a year.
- "Benefits" is determined under §410(b).
- Example
  - Plan's benefit is the greater of the 12/31/19 accrued benefit or 2% of compensation times years of participation up to 10 years.
  - Key Employee has an accrued benefit of 30% of compensation as of 12/31/19. Key Employee's accrued benefit does not increase in 2020.
  - BUT under §410(b) that participant is considered to be benefiting and Top Heavy benefits are not frozen.
What is the §401(a)(26) test

- Current Year Test
- In the plan year, 40%/50 employees must have an accrual of at least 0.5%
- Testing compensation follows §401(a)(4) testing rules
- May use current year of accrued to date testing
- Participant must be benefiting to be included in test.

What is the §401(a)(26) Requirement

- §401(a)(26) requires that the plan benefit the lesser of
  - 50 employees, or
  - 40% of nonexcludable employees
- But, in no event, less than 2 employees, unless there is only one nonexcludable employee
- For this purpose, excludable is any employee who has not met the plan’s age and service eligibility requirements.
- Example
  - If the plan has 2 year eligibility, then all employees with less than two years of service are excludable.

What is the §401(a)(26) test

- The most likely challenge a frozen plan will face is meeting the requirements of §401(a)(26)
- §401(a)(26) does not test whether benefits, or coverage are non-discriminatory (or does it???)
What is the §401(a)(26) test

• Example Current Year Test
• Kevin and Norm each accrue a benefit in the current year and the accrual is at least 0.5% of compensation.
• Plan is hard frozen 12/31/19. Current year testing shows no one is benefiting under current year testing

What is the §401(a)(26) test

• Example Current Year Test
• Richard and Lauren each accrue meaningful benefits in the current year
• Plan is amended 1/1/20 to accrue 0.5% a year. That formula effectively freezes benefits. However, participants are deemed to be benefiting under §410(b). Current year testing may be used. §401(a)(26) may be tested on current or accrued to date methods

Exemptions from §401(a)(26)
• A plan is exempt from §401(a)(26) if:
  • The plan is not top heavy
  • The plan benefits no highly compensated employee or former highly compensated employee and
  • The plan is not aggregated with another plan in order to allow the other plan to satisfy §§401(a)(4)/410(b) (other than for the average benefit percentage test)
Exemptions from §401(a)(26)

- A plan is exempt from §401(a)(26) if:
  - Plan benefits are hard frozen
  - The plan is covered under Title IV of ERISA and,
  - The plan does not have sufficient assets to pay all benefits
    - Schedule SB must contain an actuarial certification to that effect
  - What must the certification look like?
    - If FT+TNC is less than plan assets but termination liability is more than plan assets. Is this plan underfunded?
  - Thus, if a Title IV Top Heavy Plan is underfunded, this exemption applies

Exemptions from §401(a)(26)

- A plan is exempt from §401(a)(26) if:
  - Plan benefits are hard frozen
  - The plan is covered under Title I of ERISA and,
  - The plan is not Top Heavy
  - The plan does not have sufficient assets to pay all benefits
    - Schedule SB must contain an actuarial certification to that effect

Exemptions from §401(a)(26)

- Plans that are exempt from §401(a)(26) if:
  - Plans of governmental entities
  - Multi-employer plans
Exemptions from §401(a)(26) (Included in the Secure Act)

A plan is deemed to satisfy §401(a)(26) if:

- Benefits are frozen for all participants or for a closed class of participants.
- The plan met §401(a)(26) as of the date benefits were frozen
- Plan was in existence for at least 5 years before being frozen
- During the 5 year period prior to the freeze date, benefits or coverage were not increased
- Rule addresses the design where a portion of a plan is hard frozen while another group is continuing to accrue benefits
- Likely this rule will be interpreted to apply only to large plans

What happens if a plan is frozen?

- If a plan is frozen and does not meet the exceptions, then under the regulations the plan must satisfy testing under the prior benefit structure rules
- Under this rule testing may be done on current employees or on the combination of current and former employees

What happens if a plan is frozen?

- The regulations have the further requirement at §1.401(a)(26)-3(c)(2) that “A plan does not satisfy this paragraph (c) if it exists primarily to preserve accrued benefits for a small group of employees and thereby functions more as an individual plan for the small group of employees or for the employer.”
- This applies even if the plan meets one or more of the exemptions.
What happens if a plan is frozen?

• So consider a doctor plan that is frozen
• 95% of the value of plan benefits is for the doctor
• At what point is the primary purpose of the plan for the preservation of the previously accrued benefit for the doctor (and thereby not satisfy §401(a)(26))?  

IRC §401(a)(26) Prior Benefit Structure

• A frozen plan may satisfy §401(a)(26) if it meets the Prior Benefit Structure testing
• 40% of current employees or 40% of former employees but no less than 2 if more than 1 nonexcludable employees have accrued or are accruing meaningful benefits
• This test does not apply if the plan exists to preserve benefits for a small group of employees
• Regulation is worded for a small group of employees. IRS in practice has been applying this standard when the small group is composed of HCEs
• Example: A plan benefits HCEs and NHCEs. Plan is frozen with the majority of the benefits are attributable to HCEs. This plan might not meet the prior benefit structure

How Does §401(a)(26) apply to frozen plans

• Soft Frozen plans and Partial Frozen plan may pass §401(a)(26) on current benefit structure testing
• Hard frozen plans might have to make use of the prior benefit structure testing
Testing a prior benefit structure

• If the plan is testing the prior benefit structure then first the people included in the test must be determined
• Which ones of those people who have a meaningful benefit must be determined (i.e. have an EBAR (by definition, using accrued to date) of at least 0.5% of pay)

Testing a prior benefit structure

• If the test is based upon current employees, then the determination of who is included is done as described previously
• If the test includes former employees, then non-excludable former employees must be determined (§1.401(a)(26)-6(c))

Testing a prior benefit structure

• The test then requires that the plan satisfy the 50 employee or 40% test, or
• The plan benefits at least 5 former employees AND EITHER
  • The plan benefits 95% of the former employees with a vested benefit, or
  • At least 60% of the former employees who benefit under the plan are NHCEs
Testing a prior benefit structure

• Under the regulations, all former employees must be included, except
  • The plan may optionally exclude employees who terminated before January 1, 1984 or prior to the 10th calendar year prior to the calendar year in which the current plan year begins

Testing a prior benefit structure

• After excluding employees who terminated more than 10 years prior to the current year
  • All former employees must be included
  • Except employees who never met the plan’s age and service requirement

Testing a prior benefit structure

• Normally when testing benefits for former employees, employees who were below the §411(c)(3)(ii) mandatory distribution limit (which under §411(c)(3)(ii) is determined at the time of termination) are excluded, but under §1.401(a)(26)-4(d)(2), if the participant was vested, then they are not excludable
Testing a prior benefit structure

• It appears the process is like this:
  • First, assemble a list of all former employees
  • Second, optionally eliminate those who terminated over 10 years
    prior to the current year
  • Third, optionally eliminate those who never met the age and
    service requirement
  • Fourth, optionally eliminate those who had no vested accrued
    benefit (but, only those who were actually participants)

What is left is the nonexcludable employees

• Within that group determine how many have an EBAR on an
  accrued to date basis, of at least 0.5% of average
  compensation
• Test the group with a meaningful benefit to see if an
  acceptable percentage or count

How Does §401(a)(26) apply to frozen plans

• Example Soft Freeze
• Plan covers the two nonexcludable participants, Rick
  and Larry.
• Rick’s benefit increases due to an increase in
  compensation. Larry’s benefit remains the same.
• Plan likely fails §401(a)(26)
How Does §401(a)(26) apply to frozen plans

• Within the last 10 years, the plan covered Beth (terminated in 2018), Rick and Larry.
• Beth and Rick meet the meaningful benefit threshold
• Plan meets §401(a)(26)

What is a meaningful benefit under §401(a)(26)?

• June 6, 2002 Paul Shultz Memo
• Internal memo to reviewers
• Not subject normal vetting process
• §401(a)(26) becomes a non-discrimination test
• Compares the benefits of shareholders with non-shareholders not the benefits of HCEs vs. NHCEs
• Seems to preclude floor offset arrangements if the Service does not like the results
• Mandates ½% of pay as a minimum to meet §401(a)(26)

DB/DC Top Heavy Minimums

• Typically, the design is that the employer’s DC plan provides the top heavy minimum not the DB plan
• Under DB/DC arrangements, most documents have been drafted that if an employee participates in a DB/DC arrangement then the DC plan provides the top heavy minimum that is usually 5% of pay
• Note, the language in documents references participates in a DB plan not benefits.
• Thus a hard freeze in a DB plan may still require a top heavy minimum DC allocation by the terms of the plan.
**DB/DC Top Heavy Minimums**

- Example:
- DB is frozen in 2015.
- Top Heavy minimum is provided in the DC plan.
- No allocations are made in the DC plan for 2015-2019.
- In 2020, the DB plan is amended to provide benefit accruals retroactive to 2015.
- Result is the non-key employees did not receive a top heavy minimum benefit for 2015-2019.
- Treasury regulation §1.401(a)(4)-5; timing of amendments may not be discriminatory.
- Facts and circumstances test.
- Examples of discriminatory timing of an amendment:
  - Plan frozen while it covered HCEs and NHCEs. Plan unfrozen when it covered only HCEs.
  - Plan frozen before the first NHCE becomes eligible.

**IRC §415**

- An increase in benefit due to the §415(b) cost of living adjustment (COLA) is a benefit accrual.
- If a §415(b) limit is increased because of the COLA, that increase cannot be reflected if benefits are frozen prior to the effective date of the increase. In a calendar year plan, the COLA is recognized on the first day of the plan year. Be careful of freezing a plan before participants accrue a benefit.
- Example:
  - Plan frozen on 4/30/20.
  - One HCE received a §415 COLA increase on 1/1/20.
  - If no other employee accrued a benefit, there may be problems with §§401(a)(26) and/or §410(b).

- Service when the plan is frozen is recognized while the plan was frozen and may be used if benefits become unfrozen.
- Example: Participant had four years of participation when the plan was frozen. Five years later the plan is unfrozen. For purposes of §415, the participant’s years of participation at the unfreeze date is nine years.
- Please note that the above explanation is my interpretation of the regulations. Other professionals may not agree with me. If the plan covers NHCEs, recognition of service for §415 while the plan is frozen and subsequently unfrozen may cause discrimination issues.
Funding Issues
• Example:
  • 2019 calendar plan year. Plan terminated effective 1/3/19
  • If the valuation date is the beginning of the year, the plan termination cannot be recognized without a §412(d)(2) election.
  • A 2019 end of year valuation must recognize the termination date.

Funding Issues
• Example
  • Plan uses an end of the year valuation date
  • Plan terminates effective 1/3/20
  • Pursuant to regulation §1.430(a)-1(b)(5)(ii) the valuation date cannot be after the plan termination date
  • Due to the plan termination, the valuation date is changed to the beginning of the year.
  • Must the employer make a §412(d)(2) election?

Consulting Issues
• Clients perceive a freeze means contributions are not required
• Clients think our work is easier when the plan is frozen
• Frozen plans may allow substantial deductible contributions. However, you may run afoul of §401(a)(26) with an over-funded frozen plan
• Clients may want to contribute to a frozen plan but §404 limits may prevent any meaningful contribution
• After benefit accruals are restored, the §404 Cushion is not very large
• What are the clients goals when freezing a plan?
  • This is a temporary measure at best
  • Preamble for a plan termination
  • If the employer’s employee population changes, §§401(a)(4) and 401(a)(26) may become problems. Also, always ask for current census information even if it does not impact the valuation
• Never assume a client’s goals have remained the same.