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Freezing a Defined Benefit Plan to Reduce Current Year Contribution Obligation

By David Hochman & James Shaw

Defined benefit pension plans, including cash balance plans, require a contribution each year, which is primarily used to fund the benefits which participants accrue (i.e., earn) during the plan year. The annual required contribution may also include an amount needed to make up a shortfall in a prior year in the investment return on plan assets.

In most defined benefit pension plans, a participant earns a benefit for a plan year after working 1,000 or more hours during that year. Once a benefit for a plan year has accrued, the contribution required to fund that benefit becomes a fixed obligation of the employer maintaining the plan. An employer failing to make the minimum required contribution is subject to a series of nondeductible excise taxes – in addition to the required contribution.

Small employers have been hit particularly hard by the COVID-19 pandemic and in most cases have reduced or stopped operations. At the same time, the stock market has declined sharply, which, absent a prompt recovery, will likely increase an employer’s contribution to its defined benefit pension plan. As one result of these events, employers are looking at ways to reduce business expenses.

While termination of a defined benefit pension is one possible solution, this could actually result in an even larger employer contribution being required for 2020, particularly when the value of plan assets has declined. In many cases, a better solution to reduce an employer’s contribution to its defined benefit pension plan for the 2020 plan year is to cease or “freeze” the accrual of benefits. Freezing a plan requires advance written notice to plan participants and, in most cases, an amendment to the plan document. A “small plan” (fewer than 100 participants) requires 15 days prior written notice of freezing while a “large plan” (100 or more participants) requires 45 days prior written notice. To be effective for the 2020 plan year, these actions must be completed before participants have earned a benefit for this year. Accordingly, for a large calendar year plan, the deadline for accomplishing this would generally be on or prior to May 1, 2020 and prior to June 1, 2020 for a small calendar year plan. Freezing the plan for 2020 does not totally eliminate the contribution for 2020. There may still be a contribution needed to makeup investment losses of the plan in prior years. However, the contribution needed to amortize such losses can typically be spread over a period of several years and are going to be less than if the plan is not frozen.

Freezing a plan does not have to be permanent. If the financial markets rebound and businesses are able to resume normal operations, an employer could “unfreeze” its defined benefit plan.

For any questions or additional questions about this Alert, please contact one of the listed Roetzel attorneys.

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Note: The foregoing pertains to a single employer plans maintained by an employer for its employees and does not apply to a multi-employer plan subject to a collective bargaining agreement.

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