Are There Risks to Contributing More Than the Minimum to a Cash Balance Plan?

Facts

I set up a cash balance plan two years ago and have put in the minimum required contribution each year. Now, in my third year, I would like to make the maximum deductible contribution, which is double the amount of the minimum.

Question

Are there any risks in contributing more than the minimum contribution to the cash balance plan?

Answer

As any good actuary will tell you, the answer is "it depends". That leads to the next question of, "it depends on what?" That is a great question. The level of risk in contributing more than the minimum contribution to a cash balance plan depends on:

- How much greater the contribution is over the minimum?
- When is the contribution going to be made?
- What do you want the contribution to be in the future?
- When are you planning to retire?
- Who else are participants in the plan?

There are a few other issues to consider, but these are the most important and will be enough to get our conversation started.

The instances when there are potential problems are a result of to the risk of having to terminate an overfunded plan. Surplus assets that revert to the plan sponsor are subject to a 50% excise tax and regular tax. There are ways to decrease and/or eliminate the excise tax, but that is for another week. For now, we will just go with the notion that we do not want an overfunded plan at termination.

All retirement plans must follow this equation:

(C)ontributions + (I)nvestment Income = (B)enefits + (E)xpenses

Since a cash balance plan is a defined benefit plan, the benefit (B) is defined and the contribution (C) varies as the investment income (I) varies. Let's take a look at an example using the following assumptions:

I = 0% net of all investment fees (allows us to eliminate investment of investment returns for the example)
B = $100,000 per year as a contribution credit and a 0% interest credit
E = $0 (all expenses are paid by the plan sponsor)

If we know you are going to retire at the end of the fifth year of the plan then we know, at retirement, B will equal $500,000 (5 years x $100,000 per year), C will equal $500,000, and I will equal $0.

What if in year three, instead of contributing $100,000, you deposit a contribution of $200,000? This is where the “it depends” becomes important. Here are instances where there probably will not be a problem:

- You skip the contribution in either year four or five.
- You make the contribution in years four and five. You also delay your retirement to the end of year six with no contribution in that year.
- You make the contribution in years four and five. Since the plan is not at the maximum benefit level, you amend the plan in year five to increase the contribution credit to $200,000.

What happens if you retire at the end of year three, and there is no room to increase benefits? The easiest solution is to make sure that you work at least one day in the fourth year and change the requirement to receive a contribution credit to only one hour of service. That means you accrue another $100,000 in contribution credits to “absorb” the additional contribution made in year three.

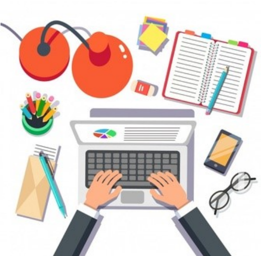
One option that always helps is to wait to deposit the excess contribution until the first of the year, e.g. January 2020, rather than December 2019. As soon as we cross into the next plan year, we know we can change the contribution accrual requirement. Also, this provides a timing cushion in case the situation changes such that the plan needs to be terminated immediately (for example, the death of the participant) or the maximum no longer makes sense (dramatic spike in the investment earnings).

In our example above where we assume a 0% investment return, what if, in year four, a $200,000 contribution is desired? As long as the fifth-year contribution is $0, then we are OK. However, what if in the second month of the fifth year the assets increase 25%? If the additional $100,000 is made during the fourth year, then the plan is overfunded. If the additional $100,000 is planned to be deducted for the fourth year, but not contributed until the tax filing deadline (sometime in the fifth year), then the additional contribution can be changed to $0 after the assets spike.

Pre-funding a defined benefit plan beyond the minimum eliminates a great deal of the risks associated with required funding. However, options must be in place so that when it is time to terminate the plan, the B has time to catch up with the C + I. As always, please contact us at DWC with any questions.

Related Resources

- Cash Balance Plans 101



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