

Cash Balance Plans

Understanding the Funding Range

A cash balance plan is an excellent retirement vehicle for owners, partners and highly compensated employees to receive significant retirement contributions above and beyond a traditional 401(k) and profit sharing plan. With input from the client and their advisors, an actuary determines the interest crediting rate as well as unique cash balance pay credits for each employee. The pay credit is calculated using factors such as eligible compensation, age and employee status. The sum of each participant's interest credits and compensation credits makes up their Theoretical Account Balance.

Contributions are calculated after the end of a plan year and the plan sponsor receives a report detailing the amount of money to be credited to each eligible employee. This report often includes three funding options. Why are there three funding options and which one should be used? Let's review these options and analyze situations where each should be utilized.

Typically, the following three funding values are provided to cash balance clients:

- 1) Minimum Required Contribution (MRC)
- 2) Amount to "fully fund"
- 3) Maximum Deductible Contribution

1) Minimum Required Contribution (MRC)

IRS regulations prescribe the calculation of the MRC. The MRC is equal to the Target Normal Cost for the year plus the amortization of any unfunded liability. In other words, the MRC is equal to the present value of benefits attributable to the current plan year (i.e. Target Normal Cost), plus any amount that needs to be made up from declining asset values in previous years. Also, administrative or actuarial fees paid by the plan are added to the Target Normal Cost.

2) Amount to "fully fund"

This number conveys the amount needed to make the sum of the Theoretical Account Balances for all participants equal the exact asset balance in the plan at the end of the year. If a fully funded plan were to terminate on the last day of the plan year, and all benefits were to be paid to the participants, the plan assets would equal the benefits payable from the cash balance plan.

This funding value is typically used when the plan is nearing its useful life and will be terminating in the near future. However, often the actuary prefers that this funding value be used so that the differential between liabilities and assets is not too great.

3) Maximum Deductible Contribution

IRS regulations prescribe the calculation of the maximum deductible amount. As you know, one of the many benefits to business owners is the deductibility of contributions to a cash balance plan. The maximum deductible contribution is calculated as 150% of the Funding Target, plus the Target Normal Cost, less Assets. In other words, the maximum deductible contribution is equal to 150% of the present value of benefits attributable to years prior to the valuation date (i.e. the Funding Target), plus the present value of benefits attributable to the current plan year (i.e. Target Normal Cost), less Assets.

For businesses looking to maximize their tax deduction, this funding value is used. However, contributions at or near the maximum deduction may result in a reduction in the amount of contributions allowed in future years. Also, the IRS limits the amount that may be distributed to a participant in a cash balance plan. Excess assets can create adverse tax consequences. Thus, if you are considering a large contribution you should consult with the actuary.

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In the End...

The plan sponsor, CPA and financial advisor should discuss the funding values with the actuary to review the benefits and costs of making the annual contribution. It is also prudent to review the investment performance and asset value of the cash balance plan to ensure the plan is operating properly.

A cash balance plan is a powerful retirement tool. For questions about your plan or to implement a cash balance plan, contact Pinnacle Plan Design.

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