Contribution Funding Requirements

Overview of Funding Requirements for Defined Benefit Plans

This document provides an overview of the funding requirements for Pension Plans, including Defined Benefit and Cash Balance Plans. It includes a discussion of the minimum and maximum funding requirements, tips for keeping the plan funded at or above the minimum level, steps to minimize or avoid costs and fees that may be incurred if a plan becomes under or over funded, and provides answers to frequently asked questions.

Overview

ERISA requires Pension Plans, including Cash Balance and Defined Benefit Plans, to maintain a minimum funding level each year to ensure adequate assets are available to pay participant benefits upon termination of employment (or upon termination of the plan).

With Pension Plans, the employer can choose from a range of funding amounts each year. The difference between the minimum and maximum funding amounts can be quite large.

While this range provides an opportunity for tax planning, regularly contributing the minimum or maximum amounts may cause the plan to be subject to special requirements and can lead to unplanned costs, excise taxes, or government filings.

What are the minimum funding requirements? The plan's actuary is required to make an annual calculation that measures the plan's liabilities compared to assets along with benefits accrued during the year. This calculation is used to determine the minimum funding requirement for the year. The minimum amount will accrue interest monthly and will increase until funded. JULY's actuary will provide a schedule that shows the contributions plus interest based on the month funded.

In addition, the actuary makes another calculation called the Adjusted Funding Target Attainment Percentage (AFTAP) to measure the plan's funded status. Special rules are imposed on plan's whose AFTAP falls below 100%.

What is the Impact of Being Underfunded?

Below is an overview of the implications when a Pension Plan becomes underfunded.

1. **Larger Future Contributions** - If the plan becomes underfunded, the employer is required to contribute larger amounts in the future.
2. **Higher PBGC Premiums** – If the plan is underfunded, it results in higher PBGC premiums. For 2025, plans are required to pay an additional $52 for every $1,000 the plan is underfunded.
3. **Quarterly Contributions** – If the AFTAP falls below 100%, the employer must fund quarterly contributions the following plan year. The first quarterly installment is due 3 ½ months after the first day of the plan year (April 15 for calendar year plans), and quarterly thereafter.
4. **Benefit Payment Restrictions** - When the plan's AFTAP falls below 80%, it becomes subject to benefit restrictions and may be limited in paying out participants in a lump sum (i.e., it may be limited to paying participants with an annuity). If the plan valuation is not completed by the third month following the plan year (April 1 for calendar year plans), the 80% limit is increased to 90%.
5. **Participant Notices** – If the plan's AFTAP falls below 80% (90% rule also applies here if valuation is not complete within 3 months of plan year), the employer must provide a notice to participants alerting them to this restriction on plan benefits.

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What is the due date for funding the minimum required contribution?
If the plan is not subject to quarterly funding requirements, minimum required contributions are due 8 ½ months after the close of the plan year (September 15 for a calendar year plan). If the plan is subject to quarterly contributions, the entire minimum contribution must still be funded within the 8 ½ month timeframe and must comply with quarterly due dates.

For tax deduction purposes, contributions must be funded by the due date of the employer's tax return (including extensions).

What if the employer fails to fund the minimum required contribution by the due date?
If the employer fails to fund the minimum required contribution by the due date, it must comply with following additional requirements:

1. **10% Excise Tax** – The employer must pay a 10% excise tax on the amount of the deficiency.
2. **File IRS Form 5330** – The employer must file IRS Form 5330 to report the 10% Excise Tax.
3. **Notify Participants** – The employer is required to notify participants alerting them that the minimum funding requirements were not met.

What if the employer fails to fund quarterly required contributions by the due date?
If a plan is subject to quarterly funding requirements and the employer fails to fund contributions by the due dates, it must comply with the following additional requirements:

1. **Participant Notice** – The employer is required to provide a notice to participants alerting them that the quarterly payment was missed.
2. **Notice to PBGC** – For plans with more than 100 participants, the employer is required to notify the PBGC of the missed quarterly payment.
3. **Additional Interest** – The employer is required to pay an additional 5% interest on the contribution until it is funded.

If the plan is subject to quarterly payments, may the employer fund all contributions early?
If the plan is subject to quarterly funding requirements, the employer can opt to fund contributions in a single lump sum; however, it is still required to fund the total of all quarterly contributions plus the additional 5% interest for any payments not made by the end of each quarter.

What is the maximum contribution and how is it calculated?
In addition to calculating the minimum required contribution, the actuary will calculate the maximum contribution which is based on allowable actuarial assumptions. For tax deduction purposes, employers may deduct what they fund to the Defined Benefit or Cash Balance Plan up to the maximum contribution amount as calculated by the plan's actuary.

Special Rules for Sole Proprietors and Partnerships
Employers which are taxed as a Sole Proprietor or Partnership may not claim an income tax deduction for pension plan contributions that are more than 100% of their earned income. When earned income has been reduced to zero, no further income tax deductions are allowed for the year.

Special Rule for Combo Plans
Employers sponsoring two plans (Defined Benefit or Cash Balance Plan and a Defined Contribution or 401(k) Plan) are subject to an overlapping deduction limit.

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What is the suggested funding amount provided by the Actuary?

The actuary also calculates and provides a "suggested funding amount" each year with the annual valuations. This is an estimate of the amount needed to maintain the plan at full funding assuming the plan were to terminate in the current year.

What is the impact of overfunding a plan?

There are several impacts that clients should be aware of if a plan becomes overfunded:

1. **Smaller Future Contributions** – If the plan becomes overfunded, it will reduce the amount of future contributions.
2. **Excise Tax on Plan Termination** – If a plan is overfunded upon plan termination, the employer is required to pay a 50% excise tax on the overfunded balance. Because of the significance of this excise tax, it is advisable that owners nearing retirement or considering terminating their plan take steps to avoid an overfunded status.

What can cause a plan to become over or underfunded and how can this be avoided?

The plan can become over or under funded for several reasons; however, the following items have the largest impact on a plan's funded status:

1. **Consistently Funding Minimum or Maximum** – The plan has a high likelihood of become over or under funded if the employer contributes the minimum or maximum amounts year-after-year. To avoid this issue, we recommend the company generally fund the "suggested" amount as calculated and provided by JULY's actuary.
2. **Investment Performance** – Another factor impacting the funding status of a plan is the investment performance on plan assets. If the investment portfolio experiences gains (or losses) that vary significantly from the plan's stated interest accrual rate, it can cause the plan to become over or underfunded. It's important that the plan's investments be managed to yield a return as close as possible to the plan's stated interest accrual rate.

Please contact JULY at 888.333.5859 for more information.