PENSION TRENDS
BY INDEPENDENT ACTUARIES, INC.

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Too Much Rope

Prior to 2008, sponsors of defined benefit (DB) pension plans were significantly limited in how much they were able to make in tax deductible contributions each year. I began my actuarial career in 1994, and for the first several years thereafter I seldom worked on a DB plan that had a maximum deductible contribution that was greater than $0. As a result, many plans were relatively poorly funded, and not in a good position to weather the financial crisis that hit the US in the year 2000. Plan sponsors found themselves having to fill in the hole left by devastating investment losses through hefty required minimum contributions, which drove many plans and their sponsors to the brink of financial ruin.

Partly in response to this, Congress passed the Pension Protection Act of 2006, the most sweeping pension-related legislation since the enactment of ERISA in the 1970s. Among many other changes, the annual calculation of maximum deductible contributions was revised to effectively allow plan sponsors to contribute amounts sufficient to fund 150% of plan liabilities. While most large corporate sponsors were unwilling/unable to contribute up to that level, this was a boon for many owners of small businesses that sponsored DB plans. For those plan sponsors, much of the appeal of having a DB plan is the ability to make very large tax-deductible contributions each year, and this new law allowed them to do so in even larger amounts than before.

Having a DB plan that's very well funded is perfectly fine, until the time comes to terminate the plan. At that point, another IRS-mandated calculation comes into play: The maximum amount that the IRS will allow a participant to roll out of a DB plan (and into an IRA or other tax-protected vehicle). When that time comes, plan sponsors may find that with the loose maximum deductible contribution calculations the IRS has given them enough rope to hang themselves.

Let's take for example the case of a sole proprietor who adopted a DB plan in 2019, when he was age 60. Each year we, as the plan's actuaries, calculate the acceptable funding range, with the lower end of the range being the minimum required contribution and the upper end being the maximum deductible contribution. The plan sponsor has funded at the upper end of the acceptable range each year, and plan investments have returned 5% each year. Through the year 2022, the plan's contribution history and asset growth have looked like this:

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Year	Min Required Contribution	Max Deductible Contribution	Actual Contribution	EOY Assets
2019	35,000	411,000	411,000	411,000
2020	154,000	305,000	305,000	736,550
2021	289,000	441,000	441,000	1,214,378
2022	0	483,000	483,000	1,758,096

In early 2023, the plan sponsor lets us know that he's retiring and that he'd like to terminate the plan and roll the assets into an IRA. The maximum amount he can roll out of the plan is based on his age, years of plan participation, and IRS limits in effect in the year of distribution. As it turns out, that maximum amount in 2023 is only $1.31M, well short of the $1.76M in plan assets. What can he do? Well, he has two options:

1. Receive the excess $450,000 as taxable income in 2023, where it will also be subject to an excise tax of up to 50% of the excess. This is obviously a situation we want to avoid, if at all possible.

2. Keep the business alive and the plan open for one or two more years, without contributing anything more, so that additional years of plan participation and increases in IRS limits will eventually "soak up" the excess assets and allow everything to be rolled over.

Of the two, option 2 is likely most attractive, but what if the plan sponsor had died in 2023? That automatically triggers a plan termination, and his beneficiaries are left paying the income tax and excise tax on the excess assets.

The bottom line is that, while it may be tempting to maximize deductible contributions each year, DB plan sponsors need to be careful not to overdo it. That's why it's important to have an actuary working on the plan who proactively consults with you, rather than just "crunching the numbers". If you'd like to learn more about our actuarial consulting services, please contact us at info@indact.com.

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