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Information Release

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Cash Balance Interest Crediting Rates: New Options Create New Issues

On October 19, 2010, the Internal Revenue Service (IRS) issued final and newly proposed regulations enhancing Cash Balance (hybrid) retirement plans. Among the highlights are new provisions allowing plan sponsors much greater flexibility in choosing an Interest Crediting Rate (ICR).

This information release summarizes some of the potential issues when using an ICR other than a traditional safe-harbor such as the 30-year Treasury rate.

Background

A Cash Balance Plan is a defined benefit plan that specifies an employer contribution along with an Interest Crediting Rate (ICR) that cannot exceed a "Market Rate of Return." Plan sponsors invest plan assets collectively and each participant has an account. Prior to October's new regulations, the IRS had not finalized the definition of a "Market Rate of Return." Previous guidance allowed several safe harbor rates including the 30-year Treasury rate. These remain as safe harbor rates under the final regulations. However, the new regulations dramatically expand the definition of "Market Rate of Return," as outlined in our October 2010 Information Release.

New Interest Crediting Rates: Impact on Compliance Testing

The advantages of the new Interest Crediting Rates, such as setting the ICR to equal the "actual return on plan assets," will be appealing to many plan sponsors. This option eliminates most of the over-funding and under-funding issues that created challenges for some employers.

However, choosing an ICR other than a safe-harbor rate creates new issues that require caution and careful planning. Below is an explanation of how an 'actual rate of return' ICR might impact IRS compliance testing.

Meaningful Benefits Test

A Cash Balance Plan must satisfy a number of different requirements in order to pass non-discrimination testing. The ICR impacts many of these tests, including the Meaningful Benefits Test, which requires a minimum number of participants to receive a "meaningful benefit."

That number is the lesser of 1 and 2 below:

1. *At least 40% of eligible employees or*
2. *50 total employees*

A “meaningful benefit” is an annual benefit accrued as 0.5% of pay, paid as a lifetime annuity at retirement age. Since these “meaningful benefits” are based on age and compensation, they can be different for each employee. Because we must use the ICR to calculate the 0.5% of pay benefit at retirement age, the “meaningful benefit” can vary greatly. It increases as the ICR decreases.

For example, a 30 year old employee earning a $40,000 annual salary is considered to receive a “meaningful benefit” as follows:

Interest Crediting Rate	Meaningful Benefit
9.5%:	$71
4.5%:	$528
1.5%:	**$1,951**

This example illustrates that the cost to provide “meaningful benefits” can increase significantly as the ICR decreases.

Non-Discrimination Test

Non-discrimination testing, or “cross-testing,” ensures that qualified plan benefits do not disproportionately favor highly compensated employees (HCEs). In order to pass testing, Cash Balance contributions are often combined with 401(k) Profit Sharing plan contributions. The ICR used by the Cash Balance Plan will impact this test as well.

In the example below, if the ICR is **4.5%**, the employer must provide a Profit Sharing contribution of **7.5% of pay** to the employees. However, if the ICR increases to **10.0%,** the required Profit Sharing contribution for employees would increase to **11% of pay.** That’s an increase of 3.5% of payroll.

				4.5% ICR	10% ICR
	Age	**Pay**	**Cash Balance**	**Profit Sharing**	**Profit Sharing**
Owner 1	65	$ 245,000	$ 200,000	$ 32,500	$ 32,500
Owner 2	45	245,000	75,000	32,500	32,500
Subtotals		**$ 490,000**	**$ 275,000**	**$ 65,000**	**$ 65,000**
				7.5% of Pay	11% of Pay
Employee 1	50	$ 85,000		$ 6,375	$ 9,350
Employee 2	40	60,000		4,500	6,600
Employee 3	30	50,000		3,750	5,500
Employee 4	25	40,000		3,000	4,400
Subtotals		**$ 160,000**		**$ 17,625**	**$ 25,850**
Grand Totals		**$ 650,000**		**$ 82,625**	**$ 90,850**

This example illustrates that the cost to pass testing can increase significantly as the ICR increases.

When looking at these two tests together, it is interesting to note that as the ICR decreases, the cost to provide meaningful benefits increases, but that as the ICR increases, the cost of employer contributions needed to pass non-discrimination testing increases. A plan sponsor who wishes to use one of the new ICR options must carefully review the impact of the ICR on these tests to avoid additional required employer contributions.

New Interest Crediting Rates: Impact on Lump Sum Payments

The ICR can also impact the final benefit paid to a participant from a Cash Balance plan. Benefits are paid as either a lump sum or an annuity, and cannot exceed the maximum amounts set by the IRS.

If the ICR at time of payment is higher than 5.5%, which is the rate used to determine the maximum lump sum, and the annual benefit formula is set to accrue benefits at the maximum lump sum level, it is possible that the ultimate lump sum payable will be less than the account balance.

For example, the maximum lump sum payment for a 50 year-old participant would vary depending on the ICR at time of payment:

Interest Crediting Rate	Account Balance	Maximum Lump Sum Payment
5.5%	$1.2 million	$1.2 million
12.5%	$1.2 million	$350,000

In this example, the 50 year-old participant would be expecting a lump sum payout of $1.2 million, his hypothetical account balance. However, if the ICR is greater than 5.5% at the time of payout, this would not be possible. If the ICR was 12.5% at the time of payout, he would only be able to receive a lump sum payment of $350,000.

Being unable to pay a participant his entire account balance as a lump sum would be a major problem for most plan sponsors. Possible solutions include only paying out lump sums during plan years when the ICR is at 5.5% or below, opting for an annuity, or putting a cap on the ICR. This example highlights just a few of the issues that plan sponsors must review when considering one of the new ICR options.

Recommendation

The advantages of the new Interest Crediting Rates, such as setting the ICR equal to the "actual return on plan assets," are appealing to many plan sponsors. However, it is also clear that for some plan sponsors, this option could generate unexpected costs and complications.

It might make sense for many plan sponsors to continue with a safe-harbor rate such as the 30-year treasury. Alternately, they could set the ICR equal to "actual return on plan assets" while continuing to invest in a strategy that tracks a safe-harbor rate.

We recommend that an **ICR Impact Analysis** be performed to determine how using an ICR other than a safe-harbor rate might affect plan design. Kravitz consultants will be advising our clients of next steps to proceed with this analysis over the next year. If you would like Kravitz to assist you with such an analysis, please contact us. Please also visit www.CashBalanceDesign.com for more information.

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