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Notes

Cash Balance 201

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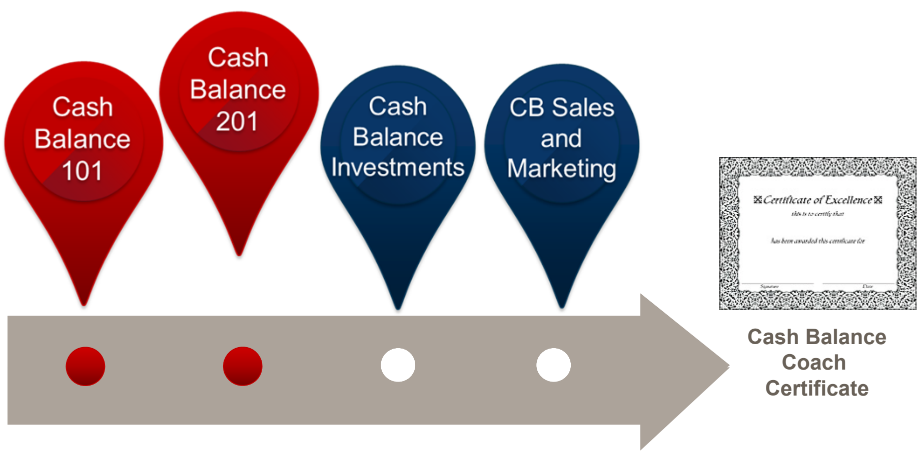
Kevin Palm, MSPA, MAAA
Retirement Plan Sales Consultant
October 5, 2017

Curriculum: 4 Modules



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Notes

Outline

Drilling deeper:

5 key design and compliance issues

1. Satisfying Non-discrimination
2. Satisfying Participation
3. Deduction Limits
4. Minimum Funding Issues
5. ICR Options

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Satisfying IRS Non-Discrimination under 401(a)(4) and 410(b)

- ✓ If New Comparability works…so will Cash Balance
- ✓ Ideal: 10+ year age disparity (some EEs)

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Notes

Example of a Challenge

2 Owners		
Hardt	45	$ 270,000
Hardt	45	$ 183,000
Subtotals		**$ 453,000**
5 Eligible Employees (>1 year)		
Gren	46	$ 45,500
Strom	56	$ 31,605
Rivera	39	$ 15,914
Anderson	46	$ 12,000
Doll	61	$11,000

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Better

2 Owners		
Hardt	45	$ 270,000
Hardt	45	$ 183,000
Subtotals		**$ 453,000**
5 Eligible Employees (>1 year)		
Gren	46	$ 45,500
Strom	56	$ 31,605
Rivera	30	$ 15,914
Anderson	32	$ 12,000
Doll	27	$11,000

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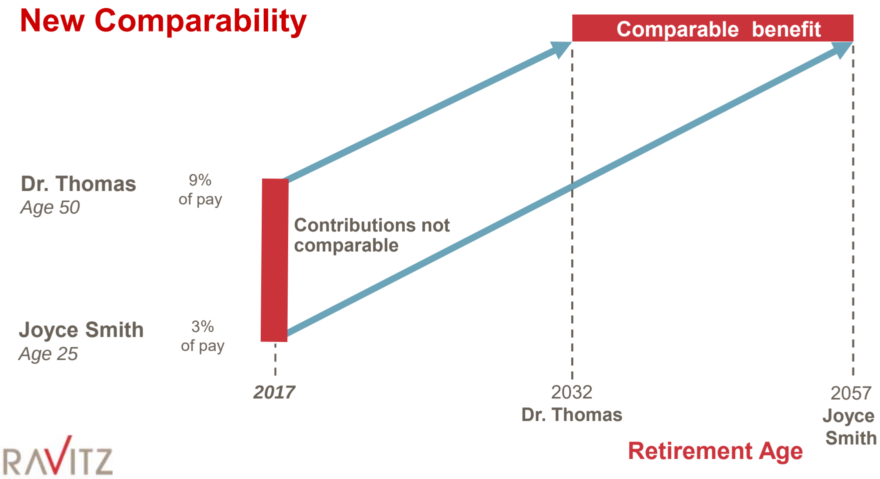
Testing for non-discrimination



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Non-Discrimination Satisfied?

Non-discrimination is *primarily* satisfied with the profit sharing contribution.

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance
2 Owners					
James Marshall	61	$ 270,000	$ 24,000	$ 36,000	$0 to $ 254,000
Tammy Marshall	56	$ 65,000	$ 24,000	$ 9,750	$0 to $ 57,000
Subtotals		**$ 335,000**	**$ 48,000**	**$ 45,750**	**$ 311,000**
4 Staff				**7.5% of pay**	
Brandon Byrd	41	$ 51,000		$ 3,825	$ 700
Jessica Jensen	34	$ 41,000		$ 3,075	$ 700
Ryan Osler	27	$ 34,000		$ 2,550	$ 700
Jimmy Bond	44	$ 21,000		$ 1,575	$ 700

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Profit Sharing Range?

5%-7.5% *(Gateway contribution)*

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance	
2 Owners						
James Marshall	61	$ 270,000	$ 24,000	$ 36,000	$0 to	$ 254,000
Tammy Marshall	56	$ 65,000	$ 24,000	$ 9,750	$0 to	$ 57,000
Subtotals		**$ 335,000**	**$ 48,000**	**$ 45,750**		**$ 311,000**
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Brandon Byrd	41	$ 51,000		$ 3,825		$ 700
Jessica Jensen	34	$ 41,000		$ 3,075		$ 700
Ryan Osler	27	$ 34,000		$ 2,550		$ 700
Jimmy Bond	44	$ 21,000		$ 1,575		$ 700

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Methods to Manage Staff Costs

- ✓ Lower amounts to certain HCEs
- ✓ Consider a higher amount for a certain job classification to avoid a higher amount for all NHCEs?
- ✓ Consider a 410(b) minimum coverage carve-out design:
  - Can consider only covering 70% of the NHCEs
  - Even less if exclude some of the HCEs
  - Example: a separate plan for Associates at a law firm
- ✓ Or consider the 401(a)(26) minimum participation carve-out to cover 40%/50 of the eligible employees…

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Satisfying Minimum Participation Requirements

- ✓ Does everyone need to be included in the Cash Balance Plan? *[401(a)(26)]*
- ✓ Does everyone need to receive a "meaningful benefit"?

1 of 2 Choices

Coverage Requirement

the lesser of:

40% of eligible participants

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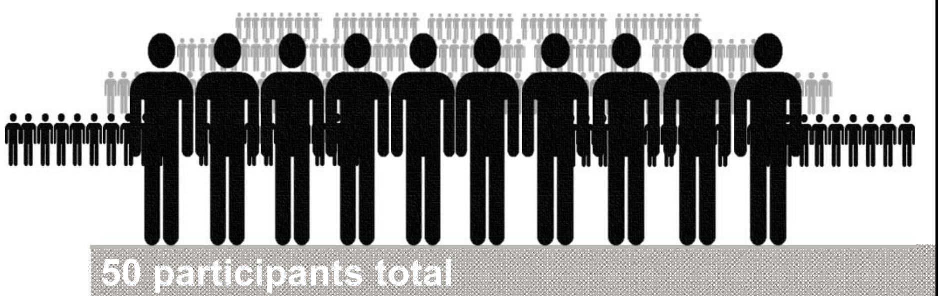
1 of 2 Choices

Coverage Requirement

OR



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Example: 40% Participating

40%= 2.4(3)

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance	
2 Owners						
James Marshall	61	$ 270,000	$ 24,000	$ 36,000	$0 to	$ 254,000
Tammy Marshall	56	$ 65,000	$ 24,000	$ 9,750	$0 to	$ 57,000
Subtotals		**$ 335,000**	**$ 48,000**	**$ 45,750**		**$ 311,000**
4 Staff				**7.5% of pay**	**Meaningful Benefits**	
Brandon Byrd	41	$ 51,000		$ 3,825		~~$ 1,560~~
Jessica Jensen	34	$ 41,000		$ 3,075		~~$ 991~~
Ryan Osler	27	$ 34,000		$ 2,550		~~$ 624~~
Jimmy Bond	44	$ 21,000		$ 1,575		$ 722
Subtotals		**$ 147,000**		**$ 11,025**		**$ 3,897**

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Notes

Case Study: 50+ Owners

Compensation	401(k)	Profit Sharing	Cash Balance	Total Contribution
53 Shareholders			(average)	
$ 270,000	$ 24,000	$ 36,000	$ 55,000	**$ 115,000**
68 Shareholders				
$ 270,000	$ 24,000	$ 36,000	$ 0	**$ 60,000**
		6% of pay		
240 Employees				
varied		$ 720,000	$ 0	**$ 720,000**

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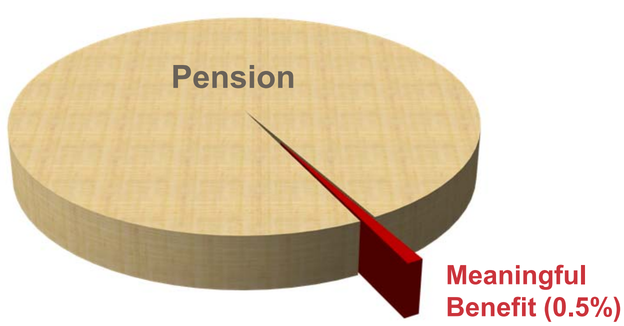
Considered "Meaningful"?

- ✓ To participate means to receive a "Meaningful benefit"
- ✓ Meaningful benefit is defined as "**0.5% of pay**, paid as a lifetime annuity, at retirement age"



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Notes

Example

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance	
2 Owners						
James Marshall	61	$ 270,000	$ 24,000	$ 36,000	$0 to	$ 254,000
Tammy Marshall	56	$ 65,000	$ 24,000	$ 9,750	$0 to	$ 57,000
Subtotals		**$ 335,000**	**$ 48,000**	**$ 45,750**		**$ 311,000**
4 Staff				**7.5% of pay**	**Meaningful Benefits**	
Brandon Byrd	41	$ 51,000		$ 3,825		$ 1,560
Jessica Jensen	34	$ 41,000		$ 3,075		$ 991
Ryan Osler	27	$ 34,000		$ 2,550		$ 624
Jimmy Bond	44	$ 21,000		$ 1,575		$ 722
Subtotals		**$ 147,000**		**$ 11,025**		**$ 3,897**

- ✓ Each participant receives their meaningful benefit
- ✓ Age and compensation drives cost
- ✓ Can consider covering just minimum of 40%
- ✓ Consider buffer to avoid annual corrective amendments

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Options to Satisfy Participation

% of pay

Meaningful benefit

Flat dollar

Name	Age	Annual Salary	401(k)	Profit Sharing	Cash Balance		
2 Owners							
James Marshall	61	$ 270,000	$ 24,000	$ 36,000	$0 to		$ 254,000
Tammy Marshall	56	$ 65,000	$ 24,000	$ 9,750	$0 to		$ 57,000
Subtotals		**$ 335,000**	**$ 48,000**	**$ 45,750**			**$ 311,000**
4 Staff				**7.5% of pay**	**Meaningful Benefits**	**2% of pay**	**Flat Dollar**
Brandon Byrd	41	$ 51,000		$ 3,825	$ 1,560	$ 1,020	$ 700
Jessica Jensen	34	$ 41,000		$ 3,075	$ 991	$ 820	$ 700
Ryan Osler	27	$ 34,000		$ 2,550	$ 624	$ 680	$ 700
Jimmy Bond	44	$ 21,000		$ 1,575	$ 722	$ 420	$ 700

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What Option to Use?

- ✓ **Actual meaningful benefits?**
  - **Pros:** The actual meaningful benefit
  - **Cons:** Gets more expensive the older the participant
- ✓ **Percent of pay?**
  - **Pros:** Gives everyone similar benefits based on pay like profit sharing contributions
  - **Cons:** Can get expensive for a high paid group
- ✓ **Flat dollar amount?**
  - **Pros:** Manages overall costs
  - **Cons:** Benefit as % of pay varies

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PBGC and Deduction Limits

- ✓ Pension Benefit Guarantee Corporation (PBGC) and tax deduction limits
- ✓ Federal agency to protect pension plans
- ✓ Leads to possibly very large deduction limits!
- ✓ But comes with a price…

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Covered by PBGC

PBGC
Protecting America's Pensions

Annual Premiums:

- ✓ 2017: $69/participant
- ✓ 2018: $74/participant

Variable Premium:

- ✓ 2017: $34 per $1,000 that liabilities exceed assets
  - $517 cap per participant
- ✓ 2018: $38*per $1,000 that liabilities exceed assets
  - $517* cap per participant

** Actual rates subject to indexing*

Plans Exempt from PBGC:

- ✓ Owner-only plans
- ✓ Professional service firms with 25 or fewer active participants

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Larger Tax Deductions!

PBGC
Protecting America's Pensions

PBGC Plans:

- ✓ NO overall deduction limit for combined CB/DC plans (Pre-PPA/"the old days" – limited to 25% of eligible pay)
- ✓ Can deduct any underfunding plus 50% Cushion Amount too!

Section 810(b) of PPA: "25% DC/DB deduction limit disregarded for purposes of applying 404(a)(7) for PBGC-covered plans.

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Example of Cushion Amount

1. Funding Target		$200,000
2. 50% of Funding Target		+ $100,000
3. Target Normal Cost		+ $200,000
4. Assets		- $200,000
Deduction Limit (1+2+3-4)	**Total**	**= $300,000**

Allows for increased deductions in a good year – prefund next year!

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What About Those Pesky Exceptions?

EXEMPTIONS

Professional service firms with 25 or fewer active participants

PROBLEM

May not be able to contribute the maximum to both plans

OPTIONS:

- Maximize CB but limit profit sharing to 6%, or
- Limit the total of both plans to 31%

Name	Age	Annual Salary	401(k)	Profit Sharing	% of pay	Cash Balance
Doctor	61	$ 270,000	$ 24,000	$ 15,900	6%	$0 to $ 254,000

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Who are "Professionals Service Employers"?

- Physicians
- Dentists
- Chiropractors
- Osteopaths
- Optometrists
- Other licensed practitioners of the healing arts
- Attorneys at law
- Public accountants
- Public engineers
- Architects and draftsmen
- Actuaries
- Psychologists
- Social or physical scientists
- Performing artists

(see CB Coach website)

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Minimum Funding Issues

- ✓ Understand annual accrual rules that drive mandatory cash contributions
- ✓ Options to manage cost for owners

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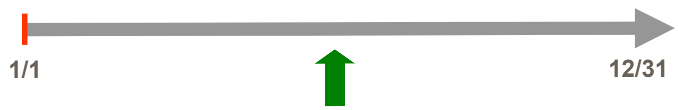
A Key Deadline



Benefits accrue to participants
(1,000 hours/~June 15)

Amendments: reducing contribution amounts – need 15-45 day notice! **Must know by May 1st!**

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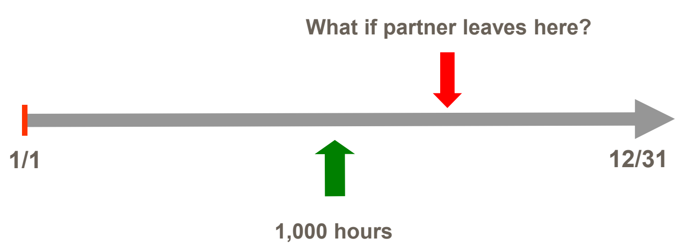
What if?



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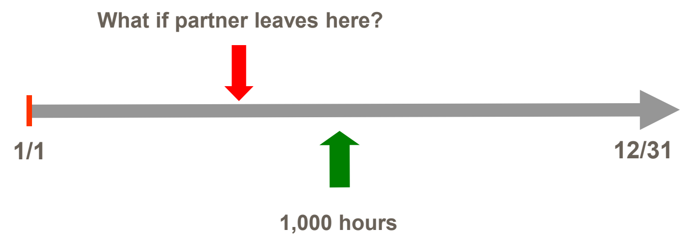
What if?



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Other Accrual Options

Accrue monthly (1/12), quarterly (1/4), semi-annually (1/2)

Issues to Consider:

- ✓ Company must fund benefits in side account and fund by due date of tax return, or
- ✓ Make periodic deposits to trust account so money can be invested

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Other Issues

- ✓ Options on how we allocate costs to partners?
- ✓ Options to handle potential shortfalls or underfunding?

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Interest Crediting Rate (ICR) Options

- ✓ Review options available
- ✓ Pros/Cons for each choice

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"Cash Balance 1.0"

Cash Balance ICR options–*prior* to 2010 IRS Regulations:

- ✓ ICR cannot exceed "Market Rate of Return"
- ✓ IRS did not clearly define "Market Rate"
- ✓ Plan sponsors relied on safe harbor rates

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"Cash Balance 1.0"

Safe Harbor Rates

- ✓ Yields on 3-month to 30-year Treasury bills/bonds
- ✓ Rate on long-term investment grade corp. bonds
- ✓ Latest Rates for September 2017:
  - 3-month T-bills: 1.03%
  - 30-Year Treasuries: 2.87%
  - Composite Corporate Bonds: 3.78% (Aug)

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Cash Balance 2.0 – New ICR Options

2010 and 2014 IRS Regulations Changed the Game!

- ✓ Actual Rate of Return
- ✓ Fixed Rates
- ✓ Equity Based Rates
- ✓ Combined Rates

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Option 1: Actual Rate of Return

ICR = Actual rate of return on plan assets

Requirement: assets *"diversified so as to minimize the volatility of returns."*

Acceptable: mix of bonds and equities

Unacceptable: exclusively in a sector fund

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Option 1: Actual Rate of Return

Advantage

Minimizes most of the underfunding and overfunding issues

Disadvantages

Volatile returns will have **significant** impact

Preservation of Capital Rule

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Option 1: Actual Rate of Return

Preservation of Capital Rule

Participant payout can never be LESS than the sum of employer contributions

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Option 1: Actual Rate of Return

Preservation of Capital Example:

↑ Employer contributes $1,000 for three years

↓ Negative return reduces participant account from $3,000 to $2,800

Participant receives the greater of:
(a) Account Balance or
(b) Sum of Employer Contributions

Payout to participant = $3,000

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An Unexpected Surprise

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Actual Rate of Return With a Twist

Biggest change in the September 2014 Cash Balance Regulations:
IRS now allows for ***different investment strategies*** *for various groups of participants within one Cash Balance plan.*

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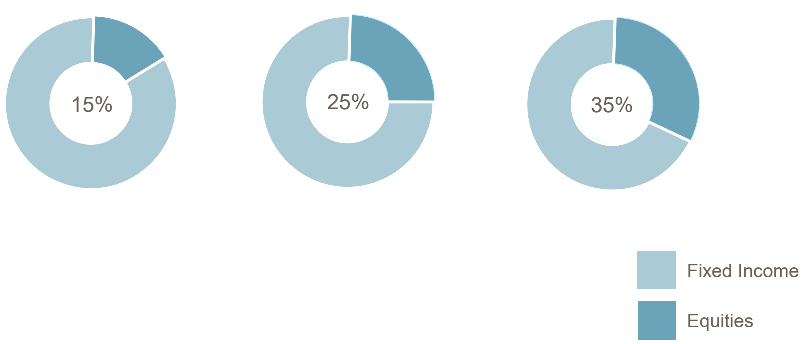
Actual Rate of Return With Investment Options



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Actual Rate of Return With Investment Options

Three Rules:

1. Diversification
2. Employer securities cannot be > 10%
3. **Employer choice, <u>not</u> participant choice**

Note: participant direction and Target Date Funds in Cash Balance plans is still 'under review' by the IRS.

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Case Study

Law Firm	Cash Balance	ICR	3 Investment Strategies
50 Partners			rs – e ners – rs – e
200 Employees			

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Option 2: Fixed Rates

A stand-alone fixed rate of up to 6% per annum

6%

Many smaller plans (less than 50 active participants) using 4% to keep contributions and benefits predictable and cost-effective

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Other Options

Option 3 - Equity Based Rates

- ✓ **Acceptable**: fund tracking the S&P 500
- ✓ **Acceptable**: fund tracking a broad-based "small cap" index
- Assets do not need to be invested in actual fund!

Option 4 - Combined Rates

- **Example**: the greater of
  (a) interest rate on long term investment grade corporate bonds or (b) 5%

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New Options Create New Issues

1. **Compliance Testing**
   - ✓ Meaningful Benefits Test
   - ✓ Non-Discrimination Test
2. **Lump Sum Payments**

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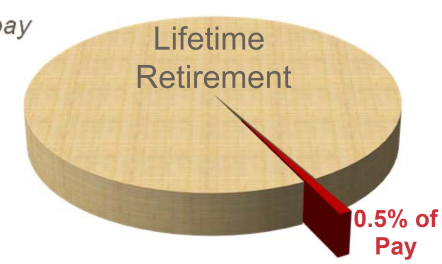
Meaningful Benefits Test

- ✓ **At least 40% of eligible employees *<u>or</u>* 50 total employees**
- ✓ **Meaningful Benefit is an annual benefit at retirement of at least 0.5% of pay**
  - Based on age & pay
  - *ICR impacts the 0.5% of pay calculation*



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Example: Meaningful Benefits Test

Example: 30 year old earning $40,000 per year

Interest Crediting Rate	Meaning Benefit
9.5%	$71
4.5%	$528
1.5%	$1,951
0.0%	$3,880

Cost to provide "meaningful benefits" can increase significantly as the ICR decreases

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Non-Discrimination Testing

Comparison: 4.5% vs. 10.0% ICR

Name	Age	Comp	Cash Balance	4.5% ICR Profit Sharing	10% ICR Profit Sharing
Owner 1	65	$ 270,000	$200,000	$36,000	$36,000
Owner 2	45	$ 270,000	$75,000	$36,000	$36,000
				7.5% of Pay	**11% of Pay**
Employee 1	50	$ 85,000		6,400	9,300
Employee 2	40	$ 60,000		4,500	6,600
Employee 3	30	$ 50,000		3,700	5,500
Employee 4	25	$ 40,000		3,000	4,400
Totals				**$19,600**	**$27,800**

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Compliance Testing

- As the ICR decreases:
  - Meaningful Benefits costs increase

- As the ICR increases:
  - Employer contributions needed to pass Non Discrimination Testing increase

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Volatility Impacts Testing

Caution: Volatility will have a **significant** impact on your Compliance Testing!

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Impact on Lump Sum Payments

IRS limit on lump sum payouts:

- ✓ Greater of ICR or 5.5% interest
- ✓ Prior to new regulations: 5.5%
- ✓ New Regulations could result in ICR > 5.5%

As ICR increases, maximum lump sum payouts decrease:

- ✓ Ultimate lump-sum can be less than what is in the account

Caution: not paying entire account balance as a lump sum is a major problem !

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Example: Lump Sum Payments

Example: 50 year old participant

- ✓ **5.5% ICR**
  - Max lump sum is $1.3M
  - Account = $1.3M - OK
- ✓ **12.5% ICR**
  - Max lump sum is $388K
  - Account = $1.3M - ☹!!!

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Possible Solutions

Solutions:

1. Only pay out lump sums when ICR is low
2. Select the annuity payout option
3. Ceiling on the ICR

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Conclusions

Advantages

- ✓ Actual Rate of Return may eliminate most overfunding and underfunding issues
- ✓ More ICR flexibility
- ✓ IRS support

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Conclusions

Disadvantages

- ✓ Testing Issues
- ✓ Lump Sum Payout Issues
- ✓ Benefit Restriction Issues

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Helpful Guide: Understanding ICRs

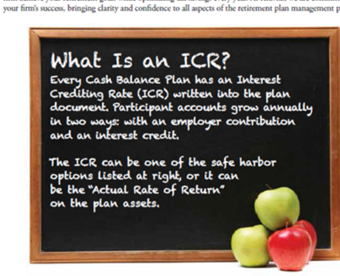
KRAVITZ CASH BALANCE RETIREMENT PLANS BY KRAVITZ

More Options
More Choice
More Freedom

CASH BALANCE PLANS: **Better than ever.**

Cash Balance plans are the fastest-growing sector of the retirement plan market for a very good reason. Think of it as a turbo-charged 401(k) with double or triple the tax-advantaged savings power. Now Kravitz has made Cash Balance plans an even better solution by introducing an innovative new option: flexible investment choices within a single company plan.

A custom-designed, tax-efficient retirement plan will strengthen your long-term financial security and will play a key role in your firm's ability to attract and retain top talent. Adding a Cash Balance plan is an important step. Enhancing your plan with investment choices takes you a step beyond the competition. This brochure is designed to help you understand the diverse options available and how they can help you and your firm achieve your retirement goals while optimizing tax savings every year. At Kravitz, we are committed to your firm's success, bringing clarity and confidence to all aspects of the retirement plan management process.



Selecting Your ICR

1. Review options with your actuarial consultant
2. Weigh pros and cons based on your plan's goals and objectives
3. ICR choice is written into plan document
4. Work with actuarial consultant and plan advisor to choose investment strategy

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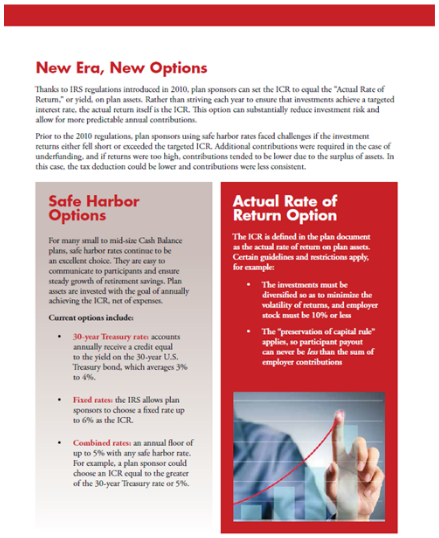
Understanding New ICR Options



New Era, New Options

Thanks to IRS regulations introduced in 2010, plan sponsors can set the ICR to equal the "Actual Rate of Return," or yield, on plan assets. Rather than striving each year to ensure that investments achieve a targeted interest rate, the actual return itself is the ICR. This option can substantially reduce investment risk and allow for more predictable annual contributions.

Prior to the 2010 regulations, plan sponsors using safe harbor rates faced challenges if the investment returns either fell short or exceeded the targeted ICR. Additional contributions were required in the case of underfunding, and if returns were too high, contributions tended to be lower due to the surplus of assets. In this case, the tax deduction could be lower and contributions were less consistent.

Safe Harbor Options

For many small to mid-size Cash Balance plans, safe harbor rates continue to be an excellent choice. They are easy to communicate to participants and ensure steady growth of retirement savings. Plan assets are invested with the goal of annually achieving the ICR, net of expenses.

Current options include:

- 30-year Treasury rate: accounts annually receive a credit equal to the yield on the 30-year U.S. Treasury bond, which averages 3% to 4%.
- Fixed rates: the IRS allows plan sponsors to choose a fixed rate up to 6% as the ICR.
- Combined rates: an annual floor of up to 5% with any safe harbor rate. For example, a plan sponsor could choose an ICR equal to the greater of the 30-year Treasury rate or 5%.

Actual Rate of Return Option

The ICR is defined in the plan document as the actual rate of return on plan assets. Certain guidelines and restrictions apply, for example:

- The investments must be diversified so as to minimize the volatility of returns, and employer stock must be 10% or less
- The "preservation of capital rule" applies, so participant payout can never be *less* than the sum of employer contributions

A KRAVITZ OFFERING:

Multiple Investment Options Within a Single Plan

New regulations introduced in 2014 created an exciting new investment approach for plan sponsors. You can now offer multiple investment options within a single plan, tailored to suit different retirement goals and needs.

Case Study: One of our large law firm clients has a customized Cash Balance plan with three investment strategies:

15% EQUITY

25% EQUITY

35% EQUITY

Ultra-Conservative: Includes participants closest to retirement age or already retired, a portfolio with 15% equities and 85% fixed income.

Conservative: A portfolio of 25% equities and 75% fixed income, covering mid-career participants and those with lower risk tolerance.

Moderate: Designed for participants furthest from retirement age, with 35% equities and 65% fixed income, seeks a 5 to 6 % annual return.

Key Advantages of an Investment Choice Cash Balance Plan:

- Meets diverse participant needs and goals
- Incorporates a range of investment strategies within a single plan
- Enhances flexibility for growing firms with many partners/shareholders
- Improves ability to attract and retain top talent

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Cash Balance 2017 Predictions

1. Continued strong CB growth driven by tax climate, economy and awareness
2. Actual Rate of Return continues to grow more popular for larger plans
3. More frequent valuations; e.g. semi-annual, quarterly or even daily!
4. Larger sponsors opt for 'investment choice' Cash Balance plans
5. CB continues to be a "must-have" for top medical/legal groups
6. CB assets grow past $1.2 Trillion by 2020
7. More investment products and income options will go to market

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Notes

Review Existing Plans

- ✓ **Cash Balance Plans are maturing**
- ✓ **Opportunities to win existing plans**
- ✓ **Consider the following design and administration issues:**
  1. Are owners' benefits at the maximum?
  2. Cost of staff increasing?
  3. Are plan admin costs reasonable?
  4. Converting from a traditional DB plan?
  5. Using a different ICR, like Actual Rate of Return?
  6. Is the client happy with quality and timeliness of actuarial services?
  7. Annual cash flow/contributions smooth?
  8. Satisfied with plan sponsor/participant websites?

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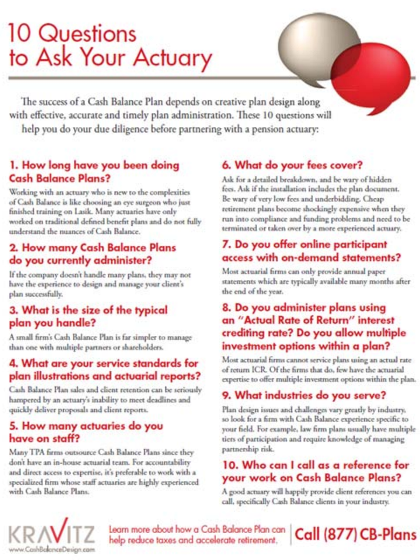
Questions to Ask Your Actuary?



10 Questions
to Ask Your Actuary

The success of a Cash Balance Plan depends on creative plan design along with effective, accurate and timely plan administration. These 10 questions will help you do your due diligence before partnering with a pension actuary:

1. How long have you been doing Cash Balance Plans?
Working with an actuary who is new to the complexities of Cash Balance is like choosing an eye surgeon who just finished training on Lasik. Many actuaries have only worked on traditional defined benefit plans and do not fully understand the nuances of Cash Balance.

2. How many Cash Balance Plans do you currently administer?
If the company doesn't handle many plans, they may not have the experience to design and manage your client's plan successfully.

3. What is the size of the typical plan you handle?
A small firm's Cash Balance Plan is far simpler to manage than one with multiple partners or shareholders.

4. What are your service standards for plan illustrations and actuarial reports?
Cash Balance Plan sales and client retention can be seriously hampered by an actuary's inability to meet deadlines and quickly deliver proposals and client reports.

5. How many actuaries do you have on staff?
Many TPA firms outsource Cash Balance Plans since they don't have an in-house actuarial team. For accountability and direct access to expertise, it's preferable to work with a specialized firm whose staff actuaries are highly experienced with Cash Balance Plans.

6. What do your fees cover?
Ask for a detailed breakdown, and be wary of hidden fees. Ask if the installation includes the plan document. Be wary of very low fees and underbidding. Cheap retirement plans become shockingly expensive when they run into compliance and funding problems and need to be terminated or taken over by a more experienced actuary.

7. Do you offer online participant access with on-demand statements?
Most actuarial firms can only provide annual paper statements which are typically available many months after the end of the year.

8. Do you administer plans using an "Actual Rate of Return" interest crediting rate? Do you allow multiple investment options within a plan?
Most actuarial firms cannot service plans using an actual rate of return ICR. Of the firms that do, few have the actuarial expertise to offer multiple investment options within the plan.

9. What industries do you serve?
Plan design issues and challenges vary greatly by industry, so look for a firm with Cash Balance experience specific to your field. For example, law firm plans usually have multiple tiers of participation and require knowledge of managing partnership risk.

10. Who can I call as a reference for your work on Cash Balance Plans?
A good actuary will happily provide client references you can call, specifically Cash Balance clients in your industry.

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www.CashBalanceDesign.com

Learn more about how a Cash Balance Plan can help reduce taxes and accelerate retirement. | Call (877) CB-Plans

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Contact Information

New Plan inquiries – by Time Zone/States

Ken Guidroz, MBA
Pacific/Mountain and Texas
(818) 379-6165
kguidroz@kravitzinc.com

Steve Stone
Central / Mid-West States
(630) 696-6200
sstone@kravitzinc.com

Carlos Tariche
Eastern / Northeast Coast
(212) 201-4120
ctariche@kravitzinc.com

Shannon Hayes
Eastern / Southeast Coast
(404) 670-1172
shayes@kravitzinc.com

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Contact Information

Kevin Palm - Nationwide
Existing Plan Opportunities
(818) 379-6168
kpalm@kravitzinc.com

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Curriculum: 4 Modules

Cash Balance Coach Certificate

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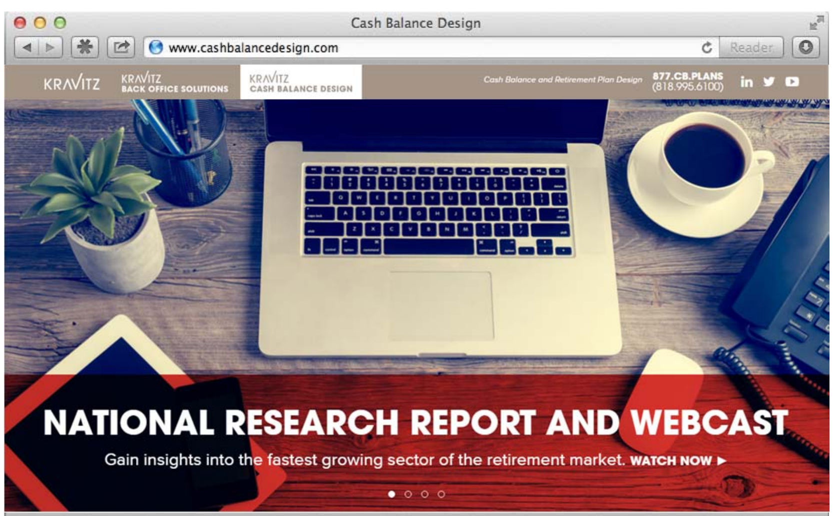

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