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Information Release

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New Rules Dramatically Expand Options for Cash Balance Plan Sponsors

Regulations Reduce Employer Investment Risk, Minimize Funding Issues and Allow for New Interest Crediting Rates

On October 19, 2010, the Internal Revenue Service (IRS) issued new regulations enhancing Cash Balance (hybrid) retirement plans. Among the highlights are new provisions allowing plan sponsors much greater investment flexibility, largely eliminating funding issues that prevented some employers from implementing Cash Balance Plans.

This information release summarizes some of the new rules and what they mean for plan sponsors. It is not a complete summary of the changes. The IRS published both **final** regulations, effective immediately, and **proposed** regulations that can be relied upon now but will officially take effect January 1, 2012.

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. Until last week, 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 and the interest rate on long term investment grade corporate bonds. As of December 31, 2009, these rates ranged from 1.80% to 5.19% with the 30-year Treasury rate at 4.49%. 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 below, creating many more options for plan sponsors.

New Interest Crediting Options

Option 1: Actual Rate of Return on Plan Assets

The regulations allow the Interest Crediting Rate (ICR) to equal the "*actual rate of return on plan assets*," including both positive and negative returns. This option is allowed as long as the employer chooses diversified investments to minimize the volatility of returns. Investing Cash Balance plan assets in a mix of bonds and equities would be acceptable. Investing exclusively in a sector fund would be unacceptable.

This new option will be highly appealing to employers since it minimizes most of the underfunding and overfunding issues. The challenges of exceeding or falling short of a targeted ICR every year are largely eliminated under this option. However, if the ICR is set to equal the Actual Rate of Return, the "preservation of capital rule" described below will apply.

Preservation of Capital Rule

Although a Cash Balance Plan may credit a negative annual return, final regulations include a "**preservation of capital rule**" to protect plan participants. No participant receives less than the aggregate amount of employer contributions at the time of withdrawal. For example, suppose a participant received annual employer contributions of $1,000 for three years, but the ICR was negative each year and the account balance decreased from $3,000 to $2,800. If the participant terminated and requested a lump sum payment, the preservation of capital rule applies, so the plan would have to pay out $3,000, even though the account balance was only $2,800.

Option 2: Equity Based Rates

The **newly proposed** regulations (which can be relied upon prior to being finalized) allow an ICR that is equal to the rate of return (either positive or negative) on a Registered Investment Company (RIC) such as a mutual fund that is reasonably expected to be not significantly more volatile than the broad United States equities market or a similarly broad international equities market. A mutual fund that is concentrated in one industry sector or one international region would **not** meet this requirement. However, a mutual fund whose investments track the rate of return on the S&P 500 or a broad-based "small cap" index would meet this requirement.

If the ICR is set to equal an Equity Based Rate, the "preservation of capital rule" described above will apply.

The plan assets do not necessarily need to be invested in the index that is being tracked. For example, the ICR could be equal to the S&P 500 index, while plan assets are invested in a fund that tracks the Russell 2000 index. If the actual return on plan assets exceeds the ICR, then this might permit the investment return to provide for the interest credit to participant accounts as well as administrative expenses and additional benefit payments that may be required under the "preservation of capital rule."

Using an Equity Based Rate rather than the Actual Rate of Return might also mitigate participants' concerns regarding the selection of investments by the employer.

Option 3: Fixed Rates and Combining Rates

The **newly proposed** regulations also allow for an ICR that equals a stand-alone fixed rate of up to five percent (5.00%).

It is also permissible for a plan to utilize an annual floor of four percent (4.00%) in conjunction with any of the safe harbor rates. For example, a plan could provide for the greater of the interest rate on long term investment grade corporate bonds or 4%.

The proposed regulations would **not** allow for the use of an **annual** floor in conjunction with the rate of return on plan assets or on an Equity Based Rate. However, it is permissible to apply a **cumulative** floor of up to three percent (3.00%) per annum in conjunction with **any** permissible rate (including Equity Based Rates).

Future Growth of Cash Balance Plans

We expect that these new regulations will accelerate the already high growth rate in Cash Balance Plans nationwide. As we reported earlier this year, there was a 359% increase in new Cash Balance Plans adopted by employers between 2001 and 2007.

The new regulations clarify lingering uncertainty about the definition of "Market Rate of Return", while opening up a broad range of ICR options that minimize employer investment risk. As traditional defined benefit plans continue to decline in popularity due to employer costs and interest rate risk, Cash Balance Plans are poised to become the dominant alternative.

Next Steps

Cash Balance Plan Sponsors and Advisors

There is much more to the new regulations than what is summarized in this information release.
At this time, it is unclear how setting the ICR at a rate other than a safe harbor such as the 30-year Treasury might impact actuarial calculations, non-discrimination testing, and the conversion of account balances to annuities.

As we continue to analyze the new rules, we will provide updates through client releases, webcasts and our website, www.CashBalanceDesign.com.

Kravitz Cash Balance Clients

Our consultants will be advising you of any changes that need to be made to your plans and of any changes that might be advisable to take advantage of the new rules. Please contact your Kravitz consultant with any questions.

Please also visit our website, www.CashBalanceDesign.com, for more information.

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(818) 995-6100 (877) CB-Plans www.CashBalanceDesign.com