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# Notes

## Understanding the New Cash Balance Plan Regulations


December 2, 2010

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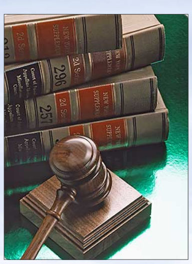
## Agenda

1. Cash Balance Overview
2. New Regulations
   - Interest Crediting Rates
   - Preservation of Capital Rule
3. Issues
   - Compliance Testing
   - Lump Sum Payments
4. ICR Changes
5. Coming Soon




## New Rules: October 19, 2010



Final Regulations

- ✓ Effective immediately

Newly Proposed Regulations

- ✓ Effective January 1, 2012
- ✓ Can rely on them now

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# Notes

## First, the Good News…

- ✓ IRS thumbs up for Cash Balance Plans
- ✓ More ICR options
- ✓ Some funding issues minimized

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## …But Proceed With Caution

- ✓ New options = new challenges
- ✓ More IRS guidance pending
- ✓ Seek expert advice before changing ICR

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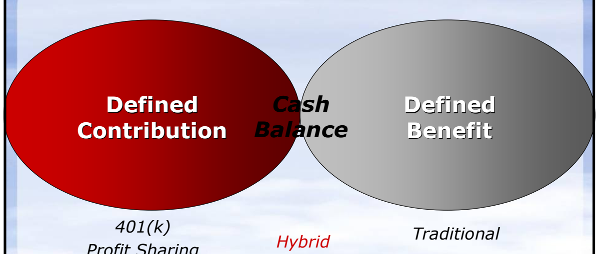
## Cash Balance Overview

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## Cash Balance Accounts

- Participants have accounts
- Accounts grow in 2 ways:
  1. Employer Contribution
  2. Interest Crediting Rate (ICR)

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## Cash Balance ICR Options

"Cash Balance 1.0" – *prior* to New 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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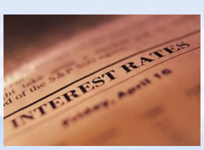
## Safe Harbor Rates

- ✓ Yield on 30-year or shorter Treasury bonds
- ✓ Interest rate on long-term investment grade corporate bonds
- ✓ Other rates listed on our website
- ✓ Ranged from 1.23% - 5.20% as of 10/31/2010

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## Cash Balance 1.0 Funding Issue

Return on Investments > ICR

Earnings ⬆ …next year's contribution ⬇

Return on Investments < ICR

Earnings ⬇ …next year's contribution ⬆




## 2010 Rules Changed the Game!

"Cash Balance 2.0" – New ICR Options

1. Actual Rate of Return
2. Equity Based Rates
3. Fixed Rates
4. Combined Rates




## Option 1: Actual Rate of Return

ICR = Actual rate of return on plan assets

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

✓ **Acceptable**: mix of bonds and equities

✖ **Unacceptable**: exclusively in a sector fund

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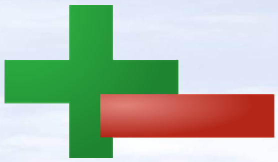
## New & Unusual!

First time ever in a defined benefit plan…

both positive and negative returns allowed.



## Option 1: Actual Rate of Return

**Advantages**

- ✚ Minimizes most of the underfunding and overfunding issues

**Disadvantages**

- ✖ Volatile returns will have **significant** impact
- ✖ Preservation of Capital Rule

## Preservation of Capital Rule

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

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## Preservation of Capital Rule

Example:

- Employer contributes $1,000 for three years
- Negative return reduces participant account balance from $3,000 to $2,800

- Greater of (a) Account Balance or (b) Sum of Employer Contributions

  Payout to participant = **$3,000**

 

## Option 2: Equity Based Rates

ICR = Return on a Registered Investment Company (RIC) such as a Mutual Fund

Requirement: *"no more volatile than the broad United States equities market or a similarly broad international equities market"*

✓ **Acceptable**: fund tracking the S&P 500

✓ **Acceptable**: fund tracking a broad-based "small cap" index

 

## Option 2: Equity Based Rates


✗ **Unacceptable**
A fund concentrated in one industry sector or one global region

 

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## Option 2: Equity Based Rates

Need not be invested in the fund being tracked

Example:

ICR = Vanguard S&P 500 index minus 1%

- ✓ Plan assets could be invested in a fund that tracks the Russell 2000 index
  - ✓Excess return covers plan expenses and Preservation of Capital Rule
  - ✓Mitigate participants' concerns about investment selection




## Option 3: Fixed Rates

A stand-alone fixed rate of up to 5%

5%




## Option 4: Combined Rates

✓ **Allowed:** annual floor of up to 4% in conjunction with any Safe Harbor Rate

*Example:* greater of (a) interest rate on long term investment grade corporate bonds or (b) 4%

✖ **Not Allowed:** an annual floor in conjunction with Actual Rate of Return or an Equity Based Rate

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## Option 4: Combined Rates

Other allowable combinations:

- ✓ A cumulative floor of up to 3% per annum with any permissible rate
- ✓ An annual ceiling in conjunction with any permissible rate

 

## Audience Poll


 

## New Options Create New Issues

1. Compliance Testing
   - ✓ Meaningful Benefits Test
   - ✓ Non-Discrimination Test
2. Lump Sum Payments
3. Benefit restrictions

 

Notes

## Meaningful Benefits Test

- ✓ At least 40% of eligible employees *or* 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

 

## Meaningful Benefits Test

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

| Interest Crediting Rate | Meaningful 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**

 

## Non-Discrimination Testing

**Comparison: 4.5% vs. 10.0% ICR**

| Name | Age | Pay | CB | 4.5% ICR PS | 10% ICR PS |
|---|---|---|---|---|---|
| Owner 1 | 65 | $245 | $200 | $32 | $32 |
| Owner 2 | 45 | $245 | $75 | $32 | $32 |
| | | | | 7.5% of Pay | 11% of Pay |
| Employee 1 | 50 | $85 | | $6.4 | $9.3 |
| Employee 2 | 40 | $60 | | $4.5 | $6.6 |
| Employee 3 | 30 | $50 | | $3.7 | $5.5 |
| Employee 4 | 25 | $40 | | $3.0 | $4.4 |
| **Totals** | | | | **$17.6** | **$25.8** |

 

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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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## Compliance 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, max 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 would be major problem !***

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## Impact on Lump Sum Payments

Example: 50 year old participant

- ✓ 5.5% ICR
  - Max Lump Sum is $1.2M
- ✓ 12.5% ICR
  - Max Lump Sum is $350K





## Impact on Lump Sum Payments

Solutions:

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





## Benefit Restrictions


- Payment of lump sum benefits could be restricted
- Higher Interest Crediting Rates could impose benefit restrictions
- See website for more information

## Changing the Interest Crediting Rate


 

## Changing the Interest Crediting Rate

ICR is an accrued and protected benefit

- ✓ Account balance of $300,000 with a 30-year Treasury ICR
- ✓ Benefit must not be less than the $300,000 accumulated each year at the 30-year Treasury yield
- ✓ Even if ICR is lowered

 

## Changing the ICR

To change the Interest Crediting Rate, must meet one of the two requirements:

1. Wearaway
2. Sum of Two Accounts

 

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## Option 1: Wearaway

Set Up Two Hypothetical Accounts:

Account A

- ✓ Beginning balance = current account balance
- ✓ Grow each year using original ICR
- ✓ No future contributions

Account B

- ✓ Same beginning balance as Account A
- ✓ Credited with new ICR and
- ✓ Add new contributions

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## Wearaway

Payout is greater of:

- ✓ Account A or
- ✓ Account B

*No participant will receive less than account balance at date of change with interest at the old ICR*

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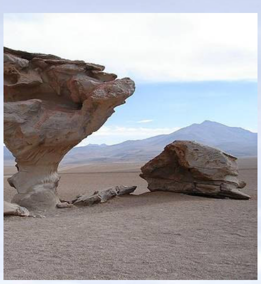
## Wearaway



The problem simply 'wears away:' after a few years Account A becomes irrelevant for most participants

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## Example: Wearaway

- Account Balance is $300,000
- Contribution is $50,000
- Old ICR is 30-year Treasury rate: 4.00%
- New ICR is actual return: 3.50%

| | Account A | Account B |
|---|---|---|
| 1/01/2011 | $300,000 | $300,000 |
| 4.0% interest | 12,000 | N/A |
| 3.5% Interest | N/A | 10,500 |
| 2011 Contribution | N/A | 50,000 |
| 12/31/2011 | $312,000 | $360,500 |

 

Notes

## Wearaway: Exceptions

Account A could be greater than Account B:

- ✓ Terminee leaves his money in the plan
- ✓ Plan is frozen and the employer elects not to make any future contributions.

 

## Option 2: Sum of Two Accounts

Set Up Two Accounts:

Account A

- ✓ Beginning balance = current account balance
- ✓ Grow each year using original ICR
- ✓ No future contributions

Account B

- ✓ Beginning balance = $0
- ✓ Credited with new ICR &
- ✓ Add new contributions

Payout is Sum of Account A + B

 

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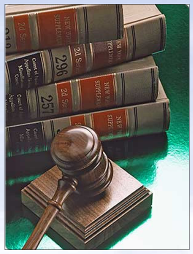
## Coming Soon?

Multiple ICRs Within a Plan

- ✓Participant Direction
- ✓Target Date Funds
- ✓Not yet available but under IRS consideration

More Frequent Valuations

- ✓Quarterly
- ✓Daily



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## Conclusions

**Advantages**

- ✓ Eliminates most overfunding and underfunding issues
- ✓ ICR flexibility
- ✓ IRS support

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## Conclusions

**Disadvantages**

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

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## Predictions

1. Many will continue using a safe harbor rate (30-yr Treasury)
2. ICR = Actual Return, but continue with a strategy tracking a safe harbor rate
3. ICR = Equity Based Rate, but add a ceiling

 

## Audience Poll


 

## Recommendation

**ICR Impact Analysis:**

1. Study impact of different ICR options on plan design
   a. Compliance testing
   b. Lump sum payouts
   c. Benefit restrictions
2. Recommend optimal ICR
3. If applicable, create a transition plan

 

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## Kravitz Clients

Kravitz consultants will advise you of next steps to proceed with an ICR Impact Analysis over the next year




## Contact Us

Anyone interested in learning more about ICR Impact Analysis or other plan design issues, please call:

**(877) CB-Plans**




- ✓ Design and administer retirement plans for 1,200+ clients nationwide
- ✓ Founded October 15, 1977
- ✓ National leader in Cash Balance Plans since 1989; founded Cash Balance Coach®
- ✓ Los Angeles & New York + 7 satellite offices

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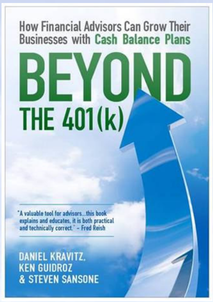
## Beyond the 401(k)

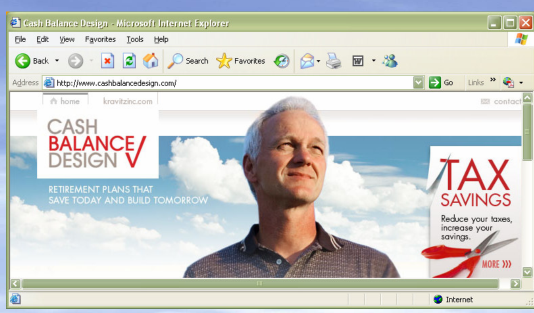



Amazon.com

CashBalanceBook.com








**CashBalanceDesign.com**