



Notes

KRAVITZ

**Understanding the 2014
Cash Balance Plan Regulations**




October 21, 2014
**Dan Kravitz, President
Kravitz, Inc.**

© 2014 Kravitz, Inc. All rights reserved.

Today's Goals

You'll learn:


1. How an exciting new ICR option works
2. When to use the new ICRs
3. How the new regulations impact the Cash Balance marketplace



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 2

Agenda

1. New CB regulations: what changed in 2014?
2. Introducing a surprise gift from the IRS!
3. Case studies
4. Opportunities & challenges:
 - ✓ Small plan sponsors
 - ✓ Large plan sponsors
5. Predictions & market outlook



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 3

Notes

New Rules: September 19, 2014



Final Regulations

- ✓ Effective immediately
- ✓ Some rules apply to plan years beginning on or after January 1, 2016

Proposed Regulations

- ✓ Impacts non-compliant plans

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 4

Good News...



✓ IRS thumbs up for Cash Balance Plans


✓ More choices and greater flexibility

✓ Exciting new ICR option

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 5

...But Proceed With Caution

- ✓ New options present some challenges, particularly for small plans
- ✓ Seek expert advice before changing ICR



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 6

Notes

Cash Balance Overview

Defined Contribution
401(k)
Profit Sharing

Cash Balance
Hybrid

Defined Benefit
Traditional

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 7

Cash Balance Accounts

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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 8

Cash Balance ICR Options

Target **Cash Balance 1.0 – prior to the 2010 IRS Regulations:**

- ✓ ICR cannot exceed “Market Rate of Return”
- ✓ “Market Rate” not defined, so plan sponsors relied on IRS safe harbor rates
- ✓ Most plans used 30-year Treasury rate

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 9



Notes

Cash Balance 1.0 Funding Issues

Return on Investments > ICR

Earnings ↑ ...next year's contribution ↓

Return on Investments < ICR

Earnings ↓ ...next year's contribution ↑

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 10

Cash Balance 2.0 – New ICR Options

2010 Cash Balance Regulations Changed the Game!

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



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 11

Cash Balance 2.0+ – New ICR Options

2014 Final IRS Regulations – Expanded the Game

- Actual Rate of Return
 - Surprise: ARR with a new twist
- Investment Based Rates
- Fixed Rates - higher limit
- Combined Rates – new options



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 12



Notes

An Unexpected Surprise



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 13

Exciting New Option!

Actual Rate of Return With Investment Options




Introducing: multiple investment strategies within one Cash Balance Plan!

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 14

Actual Rate of Return With a Twist

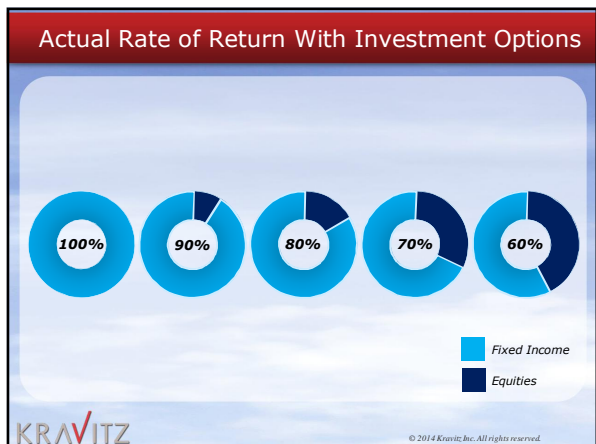
Biggest change in the September 2014 Cash Balance Regulations:
*IRS now allows for **different investment strategies** for various groups of participants within one Cash Balance plan.*



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 15



Notes



Actual Rate of Return With Investment Options

Three Rules:

1. Diversification
2. Employer securities cannot be > 10%
3. Subset of assets: market value approximate liabilities

Employer choice, not participant choice.

KRAVITZ © 2014 Kravitz, Inc. All rights reserved.

Case Study

Law Firm	Cash Balance	ICR	3 Investment Strategies
50 Partners	Only Partners participate	Actual Rate Of Return with a 6% Cap	1. Senior Partners – Very Conservative 2. Mid-level Partners – Conservative 3. Junior Partners – Less Conservative
200 Employees			

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 18

Notes


How Actual Rate of Return Works

ICR = Actual rate of return on plan assets

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

Acceptable: a mix of bonds and equities


Unacceptable: assets exclusively in a sector fund



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 19

New & Unusual

First time ever in a defined benefit plan... both positive and negative returns allowed.



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 20


Actual Rate of Return

Advantage

- ✓ Minimizes most of the underfunding and overfunding issues

Disadvantages

- Volatile returns will have **significant** impact
- Preservation of Capital Rule: potential costs if investments underperform




KRAVITZ © 2014 Kravitz Inc. All rights reserved. 21

Notes

Preservation of Capital Rule

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



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 22


Preservation of Capital Rule

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



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 23


Other Changes in the 2014 CB Regs

Change in terminology:

Investment Based Rates

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 24

Investment 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
- ✓ Assets do not need to be invested in actual fund!

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 25

Investment Based Rates

Unacceptable Investment Based Rates:

A fund concentrated in one industry sector or one global region



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 26

Example of Investment Based Rate

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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 27

Notes

New Fixed Rates

New in 2014 Regs: Increase in Allowable Fixed Rates

6%

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 28

Changes to Combination Rates

	Rate	Permitted floor
Fixed rate		
Government bond rates + permitted margin		
Investment grade corporate bond rate		
Investment-based rates		

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 29

Other Allowable Combinations




Other allowable combinations:
An annual ceiling in conjunction with any permissible rate

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 30

New Options Create New Issues

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

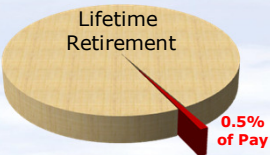
**These issues primarily impact small plans*



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 31

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*



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 32

Example: Meaningful Benefits Test

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

<u>Interest Crediting Rate</u>	<u>Meaning Benefit</u>
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

KRAVITZ © 2014 Kravitz Inc. All rights reserved. 33



Notes

Non-Discrimination Testing

Comparison: 4.5% vs. 10.0% ICR

Name	Age	Pay	Cash Balance	4.5% ICR Profit Sharing	10% ICR Profit Sharing
Owner 1	65	\$ 260,000	\$200,000	\$34,500	\$34,500
Owner 2	45	\$ 260,000	\$75,000	\$34,500	\$34,500
				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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 34


Compliance Testing

↓ As the ICR **decreases**:
↑ Meaningful Benefits costs **increase**

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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 35

Volatility Impacts Testing



Caution: Volatility will have an impact on your compliance testing!
Control with a cap

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 36



Notes

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!

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 37

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 - ☹!!!




KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 38

Possible Solutions

Solutions:

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



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 39



Notes

Large Plan Case Study			
Law Firm	Cash Balance	ICR	3 Investment Strategies
50 Partners	Only Partners participate	Actual Rate Of Return with a 6% Cap	1. Senior Partners – Very Conservative 2. Mid-level Partners – Conservative 3. Junior Partners – Less Conservative
200 Employees			

© 2014 Kravitz, Inc. All rights reserved. 40

Small Plan Case Study 1			
Small Medical Practice	Cash Balance	ICR	2 Investment Strategies
2 Partners	Only Partners participate	Actual Rate Of Return with a 6% Cap	Partner 1 – Very Conservative Partner 2 – Less Conservative
3 Employees			

© 2014 Kravitz, Inc. All rights reserved. 41

Small Plan Case Study 2			
Small Business	Cash Balance	ICR	3 Investment Strategies
2 Partners	All Partners participate	Actual Rate Of Return with a 6% Cap	Partner 1 – Option A Partner 2 – Option B
10 Employees	3 Employees Participate		3 Employees – Option C

© 2014 Kravitz, Inc. All rights reserved. 42



Notes

Issue: Meaningful Benefits Test

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

<u>Investment Return</u>	<u>Meaning Benefit</u>
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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 43

Popularity of Actual Rate of Return

30%
of Kravitz large plan clients use Actual Rate of Return

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 44

CB Interest Crediting Rates Chosen

2012

Interest Crediting Rate	Percentage*
30-Year Treasury Rate	79.2%
Fixed Rate of Return	16.0%
30-Year Treasury Rate with a Floor	2.0%
Actual Rate of Return	2.4%
Equity-Based Rate	0.4%
	100.0%


2013

Interest Crediting Rate	Percentage*
Fixed Rate of Return	42.2%
30-Year Treasury Rate	29.9%
30-Year Treasury Rate with a Floor	23.0%
Actual Rate of Return	4.4%
Equity-Based Rate	0.5%
	100.0%

KRAVITZ © 2013 Kravitz, Inc. All rights reserved. 45

Notes


Changing the Interest Crediting Rate



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 46

ICR: A Protected Benefit

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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 47

Requirements for Changing ICR

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

1. Wearaway
2. Sum of Two Accounts



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 48



Notes

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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 49

Determining Payout


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 original ICR.

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 50

Wearaway in Action




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

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 51

Coming Soon?


Participant Direction:
Currently "under further study" by the IRS



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 52

Predictions

- **Small plan sponsors:**
most will continue using safe harbor rates
- **Larger plan sponsors and owner-only plans:**
many will choose Actual Return with or without investment options



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 53

Selling Tips

1. Lead with **design**
(investments will follow)



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 54

Notes

Selling Tips

1. Lead with **design**
(investments will follow)
2. It's all about the **taxes**



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 55

Selling Tips

1. Lead with **design**
(investments will follow)
2. It's all about the **taxes**
3. Don't overcomplicate



KRAVITZ © 2014 Kravitz Inc. All rights reserved. 56

Selling Tips

1. Lead with **design**
(investments will follow)
2. It's all about the **taxes**
3. Don't overcomplicate
4. Keep investment discussion separate




KRAVITZ © 2014 Kravitz Inc. All rights reserved. 57

Notes

Recommendation

ICR Impact Analysis:




- 1. Study impact of different ICR options on plan design**
 - a. Compliance testing
 - b. Meaningful benefit issue
- 2. Recommend optimal ICR**
- 3. If applicable, create a transition plan**

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 58

Goals

Today you learned:

1. How an exciting new ICR option works
2. When to use the new ICRs
3. What changes we expect in the Cash Balance marketplace



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 59

Kravitz Clients

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



KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 60



Notes

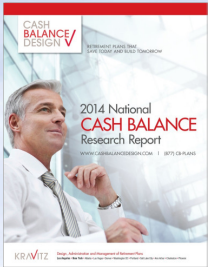
Contact Us

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

(877) CB-Plans

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 61

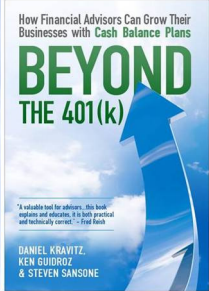
About Kravitz



- ✓ Founded October 15, 1977
- ✓ Los Angeles & New York + 7 satellite offices
- ✓ 1,200+ clients, including 500+ Cash Balance plans
- ✓ National leader in Cash Balance Plans since 1989

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 62

Beyond the 401(k)



Amazon.com

Download a free chapter at CashBalanceBook.com

KRAVITZ © 2014 Kravitz, Inc. All rights reserved. 63



Notes