KRAVITZ

Information Release

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IRS Finalizes Cash Balance Regulations, Allowing Broader Investment Options

Interest Crediting Rate Options Expanded but Questions Remain

The IRS today released new regulations for Cash Balance (hybrid) retirement plans, including a long-awaited final version of the Cash Balance regulations originally proposed in 2010. These final regulations allow plan sponsors broader options for choosing an Interest Crediting Rate (ICR), although they do not address some of the potential challenges outlined in our December 2010 Information Release. The IRS has deferred decision on some changes requested by the industry, but is allowing greater flexibility, making Cash Balance plans an even more compelling option for many employers.

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 assets are pooled and invested collectively by the plan sponsor, and each participant has a hypothetical account. Prior to October 2010, 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. The 2010 proposed regulations dramatically expanded the definition of "Market Rate of Return," as outlined in our October 2010 Information Release, allowing for certain fixed rates, investment-based rates, and the "Actual Rate of Return" on plan investments.

What Has Changed?

Actual Rate of Return

The final regulations released today allow plan sponsors who choose Actual Rate of Return as the ICR to create different investment strategies for different groups of participants. For example, a plan sponsor could use a more conservative portfolio for longer-serving employees and a different strategy for other groups of employees. Each investment strategy must meet certain requirements such as the "diversification requirement" outlined in our October 2010 Information Release. However, it is not yet clear how these different investment strategies will impact IRS non-discrimination testing and other actuarial calculations.

Fixed Rates

The final regulations allow an ICR equal to a fixed rate of up to 6%, while the 2010 proposed regulations had capped the fixed rate at 5%.

Combined Rates

Under the final regulations, plan sponsors can combine an annual floor of up to 5% with any safe harbor rate. Previously, the 2010 proposed regulations had capped the annual floor at 4%. For example, a plan sponsor can now choose an ICR equal to the greater of the 30-year Treasury rate or 5%.

Participant Direction of Investments

The option to allow participant choice of investments for the ICR is "under further study" by the IRS.

Proposed Regulations

The IRS also released proposed regulations addressing the transition from a non-compliant ICR to one that is permitted under the final rules, and has invited comments from the industry and the public on this topic.

Recommendation

The advantages of the new Interest Crediting Rates, in particular the Actual Rate of Return option, are appealing to many employers as a way to reduce investment risk. Since this option became available in 2010, more than 30% of Kravitz' large plan clients (>100 participants) have chosen Actual Rate of Return. We discussed these advantages and the growing popularity of Actual Rate of Return in our February 2014 Information Release. However, for some plan sponsors, particularly those with smaller plans, this option could generate unexpected costs and complications.

We recommend performing an **ICR Impact Analysis** to determine the effect of using an ICR other than a safe-harbor rate. Kravitz consultants will be advising our clients on how to proceed with this analysis over the coming year. If you would like assistance, please contact us or visit www.CashBalanceDesign.com for more information.

Dan Kravitz will be discussing the new Cash Balance regulations as part of the Cash Balance Coach® training program beginning October 2, and will also be hosting a public webcast on October 21. An invitation and further details will be available on our website.