KRAVITZ

Information Release

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Issues for Cash Balance Plan Sponsors When Changing the Interest Crediting Rate

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 flexibility with regards to the Interest Crediting Rate (ICR).

This information release explains what is involved in changing a Cash Balance Plan's ICR. You may find it helpful to first read our October and December 2010 information releases which provide a high level overview of the new regulations and the pros and cons of the new ICR options. To read these releases now, please click the links below:

New Rules Dramatically Expand Options for Cash Balance Plan Sponsors:
www.cashbalancedesign.com/articles/documents/NewCashBalanceRegulations2010.pdf

Cash Balance Interest Crediting Rates: New Options Create New Issues:
www.cashbalancedesign.com/articles/documents/NewICR-OptionsNewIssues2010.pdf

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 recently, 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. 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 in our October 2010 Information Release.

Changing the Interest Crediting Rate

The ICR under a Cash Balance Plan is considered part of a participant's accrued and protected benefit. In other words, if he or she has a hypothetical account balance of $300,000 with an ICR equal to the yield on 30-year Treasuries, the participant cannot receive a benefit that is less than the $300,000 accumulated each year at the 30-year Treasury yield.

Suppose a plan sponsor changed the ICR to equal the "actual return on plan assets" or a mutual fund invested in the S&P 500. In order to be sure that the plan sponsor does not reduce a participant's accrued benefit, the regulations require that the plan sponsor meet one of the two requirements outlined here:

Option 1:Wearaway

The plan sponsor must set up two accounts for each participant.

Account A

Account A would have a beginning balance equal to the current hypothetical account balance. This account would grow each year based on the yield on 30-year Treasuries (or the original ICR).

No future contributions would be added to this account.

Account B

Account B would have the same beginning balance as Account A but would be credited with the "new" ICR, such as the actual return on plan assets. Unlike Account A, Account B would also be credited with new contributions each year.

When a participant becomes eligible for a distribution, he would receive either the Account A balance or the Account B balance, **whichever is greater**. By paying the greater of the two account balances, we are assuring that no participant will receive less than the accrued benefit as of the date of the change in the ICR. For most participants, Account A will become irrelevant after a few years.

Example:

- January 1, 2011 Account Balance is $300,000
- Hypothetical Contribution is $50,000
- Old ICR is the 30-year Treasury rate which is **4.00%**
- New ICR is the actual return on plan assets which is **3.50%**

	Account A	**Account B**
1/01/2011 Account Balance	$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 Account Balance	$312,000	$360,500

If a participant is paid after December 31, 2011, he would receive **the greater of** Account A or Account B which is $360,500. Note that as long as the participant keeps receiving contributions, it is unlikely that Account A will be greater than Account B, and Account A will become less relevant.

There are some exceptions under which Account A could be greater than Account B; for example, if someone becomes a vested terminee and leaves his money in the plan. Depending on the performance of plan assets and the 30-year Treasury rate, Account A could be greater than Account B. This could also happen if the plan is frozen and the employer elects not to make any future contributions.

Option 2: Sum of Two Accounts

The plan sponsor must set up two accounts for each participant.

Account A

Account A would have a beginning balance equal to the current hypothetical account balance ($300,000 in our example). This account would grow each year based on the yield on 30-year Treasuries (or the original ICR).

No future contributions would be added to this account.

Account B

Account B would have a beginning balance of zero, but would be credited with the "new" ICR, such as the actual return on plan assets.

Unlike Account A, Account B would also be credited with new contributions each year.

When a participant becomes eligible for a distribution, he would receive **the sum of** Account A plus Account B.

Example

- January 1, 2011 Account Balance is $300,000
- Hypothetical Contribution is $50,000
- Old ICR is the 30 year treasury rate which is **4.00%**
- New ICR the actual return on plan assets which is **3.50%**

	Account A	**Account B**
1/01/2011 Account Balance	$300,000	$0
4.0% interest	12,000	N/A
3.5% Interest	N/A	10,500
2011 Contribution	N/A	50,000
12/31/2011 Account Balance	$312,000	$60,500

If a participant is paid after December 31, 2011, he would receive the **sum of** Account A and Account B or $372,500.

As outlined above, changing the ICR will require that plan sponsors setup two accounts for each participant. This will create additional administrative work and increase administrative costs.

Recommendation

The advantages of the new Interest Crediting Rates, such as setting the ICR equal to the "actual return on plan assets," will be appealing to many plan sponsors. However, it is also clear that changing the Interest Credit Rate will create additional administrative work and expenses as outlined above.

For those plan sponsors who wish to change their ICR, we recommend that a careful analysis be performed to determine the impact of using an ICR other than a safe harbor rate and to review the two options outlined above.

If you would like Kravitz to assist you with such an analysis, please contact us.

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