Cash Balance Plans

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The IRS issued new regulations late last year that enhance Cash Balance retirement plans. These new provisions could create potential issues with how individuals have been approaching the selection of the interest crediting rate (ICR) if it is something other than the 30-year Treasury rate.

In the past, many plans have had issues with over-funding and under-funding due to the difficulty in matching a selected ICR exactly. There is now a new provision that will allow you to set the ICR to return that was received on plan assets. Selecting this option, or any option other than the 30-year Treasury rate, may have their benefits but it is important to realize the implications of selecting something other than a safe-harbor as the ICR for the plan.

For one, a Cash Balance plan must pass the Meaningful Benefit Test which requires the lesser of 40% of eligible employees or 50 employees total to receive a “meaningful benefit” from the plan. A meaningful benefit is defined as an annual benefit of 0.5% of pay that is paid as a lifetime annuity when the employee retires. The ICR is involved with the calculation of how much of this meaningful benefit will have to come from employer contributions and how much will come from the actual return on the assets within the plan. The smaller the ICR is the larger employer contributions will have to be to make up for it.

For a 30-year-old employee earning $40,000 annually will receive a meaningful benefit at a cost of $71 with an ICR of 9.5%. If that ICR were to fall to 1.5%, the cost of providing that meaningful benefit is now $1,951.

The ICR also has the potential to reduce the amount of benefits received from the plan. Plan participants are given the option to select a lifetime annuity or a lump sum when receiving their benefits from the plan. A rate of 5.5% has been set to determine the maximum lump sum an individual may take from the plan. If the ICR is greater than 5.5% and annual benefits were set to accrue at the maximum lump sum level, then, the lump sum payment option may actually pay less than the account balance.

Allowing the ICR to be the actual return on plan assets may be appealing to many plan sponsors although, for many, it can create additional complications and costs in operating the plan. Despite the flexibility of this new option, we are recommending that plan sponsors continue to use safe harbor rates like the 30-year Treasury.