

SilverStone Group

EMPLOYEE BENEFITS

Defined Benefits

# More Options

## Cash Balance Pension Plans

by Glen Gahan



Cash balance pension plans received another boost from final and proposed regulations recently issued by the IRS. The regulations have allowed more employers to implement new cash balance plans or to convert existing defined benefit plans to cash balance plans by expanding the safe harbor rules for crediting interest on participants' accounts, including an option to credit the actual rate of return on plan assets.

A *cash balance pension plan* is a defined benefit (DB) plan in which an employee's benefit is equal to an account balance that increases with an annual contribution credit and interest crediting rate. The contribution credit is typically a fixed percentage of pay or a percentage of pay based on the participant's age and/or service. The regulations define the available options for the plan's interest crediting rate and limit this rate so it does not exceed the "market rate of return." Although the assets are pooled and the employer is responsible for all investment decisions, employees' benefit amounts are not directly tied to the value of plan assets.

### Market rate of return

The available safe harbor interest crediting rates have been expanded to include other bond rates and certain equity returns. Within the available options are a wide range of interest rates (currently from under 2% to over 6%), which will vary annually and include the following choices:

- Actual rate of return on plan assets\*
- First-, second- or third-segment rate as used for ERISA funding purposes
- Rate of return for certain regulated investment companies, such as an S&P 500 index fund
- Fixed rate of interest equal to 5%
- Annual floor of 4% in combination with a safe harbor Treasury rate
- Cumulative floor of 3% with any safe harbor interest rate

Setting the interest crediting rate equal to the actual return on plan assets is expected to be commonly used by plan sponsors who want to credit account balances with reasonable market-related returns and eliminate most disparities between the interest crediting rate and the actual return on plan assets that may result in over- or underfunding of the plan. Offering this type of pension plan has the potential to significantly reduce investment risk for the employer. Also, an interest crediting rate is considered not to exceed a market rate of return if it is always less than a particular interest crediting rate that meets the market rate of return limitation, or is always equal to the lesser of two or more rates where at least one of the defined rates meets the market rate of return limitation.

\*A plan is allowed to credit the actual rate of return, including both positive and negative returns, as long as the assets are properly diversified.

### Change to one of the new market rates of return

Plans that currently use an interest crediting rate in excess of these safe harbor rates are generally allowed to be amended to use a safe harbor rate prospectively. Certain anti-cutback rules may apply in some circumstances.

### Preservation of capital

The cash balance account balance payable as of any participant's distribution date must not be less than the sum of the annual contributions credited to the account. Therefore, a plan is allowed to credit an annual negative interest crediting rate for a year as long as no participant receives a distribution of his/her entire benefit that is less than the sum of the annual contributions into his/her account.

### Conversion: traditional pension plan to cash balance

In general, a traditional pension plan can be converted to a cash balance plan if the benefit after conversion is at least equal to the sum of the benefits earned before conversion, based on all plan provisions of the traditional plan (including early retirement subsidies), and the benefits earned after the conversion, based on the cash balance plan provisions.

### Which employers benefit from a cash balance plan?

Plan sponsors may decide to convert traditional pension plans or to adopt new cash balance plans based on several attractive features of the cash balance alternative:

- Benefit expressed as an account balance even though an annuity option is allowed in the plan. This may be a more attractive recruitment benefit than a traditional DB plan
- All employees eligible to benefit
- Benefits earned evenly throughout employee's career
- Pooled, professionally managed investments with higher expected rates of return than those of individually directed account balances
- Often less costly than a comparable defined contribution (DC) plan
- Less volatile employer contribution to fund the plan than a traditional DB plan
- Ability to transfer most investment risk to employees
- Plan liabilities not as sensitive to interest rate changes as a traditional DB plan
- Small business owners can save significantly more than with a DC plan

This article summarizes complex regulations into a brief overview. For more information, please contact a SilverStone Group retirement plan consultant.