

New Rules for Cash Balance Retirement Plans

IRS Issues Proposed Regulations (first of two parts)

“Market Rate of Return”

On December 28, 2007, the Internal Revenue Service (IRS) issued proposed regulations concerning Cash Balance (Hybrid) Retirement Plans. This client release will summarize how the IRS defines the “market rate of return.” It is the first of a two part information release regarding the proposed regulations.

Background

A Cash Balance Plan is a defined benefit plan that specifies the amount of contribution to be credited to each participant. The plan also provides that each participant’s hypothetical account will be credited with a specified rate of interest (interest credit).

When a participant terminates employment, he takes his vested account balance with him, just as in a 401(k) plan. All plan assets are invested together so there are no individual investment choices as in 401(k) plans.

In order for the plans to work properly, it has been necessary to set the interest credit at the 30-year Treasury rate. However, due to recent law changes, the Secretary of the Treasury has been authorized to issue regulations to address the interest credit.

Cash Balance Plans: Market Rate of Return

According to the Pension Protection Act, interest credits under Cash Balance Plans can now be set at any rate that does not exceed a “market rate of return.” The “market rate of return” can be set at any of the following rates:

- Yield on 30-year or shorter Treasury bonds
 - *This is the rate we recommend for most clients.*
- Interest rate on long-term investment grade corporate bonds
 - *This rate was added by the proposed regulations.*
- Discount rate on 3-month Treasury Bills plus 1.75%
- Discount rate on 12-month or shorter Treasury Bills plus 1.50%
- Yield on 1-year Treasury Constant Maturities plus 1.00%
- Yield on 3-year or shorter Treasury bonds plus 0.50%
- Yield on 7-year or shorter Treasury bonds plus 0.25%

As of December 31, 2007, these rates ranged from approximately 3.60% to 6.50% with the 30-year Treasury rate at about 4.50%.

A Cash Balance Plan can also provide for an interest credit that is equal to the greater of 2 or more interest credits so long as the resulting interest credit does not exceed the “market rate of return.”

It was anticipated that the IRS would make available Equity-based rates as well as provide for a fixed stated rate of return. It appears that the IRS has reserved the right to do these when they issue final regulations.

Although an Equity-based rate is not yet available, these new rules do provide some flexibility with regards to the interest credit that can be used by plan sponsors. However, if a higher rate is chosen, it may be necessary to take on more risk in the investment portfolio, which can lead to fluctuations in the annual contribution.

For most plans, the new rates will be effective for plan years beginning after January 1, 2008. However, in certain instances, it may be possible to amend the interest credit to reflect the new “market rate of return” for prior plan years. However, such amendment cannot result in a decrease of benefits.

Next Steps for Cash Balance Plan Sponsors and Advisors

There is much more to the new regulations than what is summarized in this information release. We are continuing to analyze the effects that the new law will have on our clients’ plans and will be issuing a second client release.

Our consultants will be advising you of any changes that need to be made to your plans and of any changes that might be advisable to take advantage of the new rules. Feel free to contact your Kravitz consultant with any questions.

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

This Client Release will be our final paper mailing. If you are not currently receiving our newsletters and information releases via email, please sign up at www.lkravitz.com/site/newsletter.html or email us at email@lkravitz.com.

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