May 16, 2018

The Practical Cash Balance Plan: Choosing Your Plan's Interest Crediting Rate

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When setting up your cash balance plan, choosing your plan's interest crediting rate is a critical decision point in the design process, and will likely impact the ultimate success of your objectives for the plan. What's more, the interest crediting rate that best meets your objectives may surprise you.

We hear these common objectives when we discuss cash balance plan design with our clients:

- We want maximum tax-deferred savings for retirement.
- We want to provide competitive benefits for our employees at reasonable costs.
- Each business owner should pay their fair share, no contribution or cost subsidies.
- We need predictable annual contributions.
- The plan needs to be easy to understand and explain to participants.
- Plan benefits should be portable, with lump sums available at retirement or termination of employment.
- We want to limit or minimize investment risk.

IRS regulations make a variety of interest rates and interest rate bases available for use (see the table at the end of this article), with more rules allowing plans to use multiple rates, and apply floors and caps on annual interest crediting rates (the complexity of the regulations is an actuary's dream!). The most attractive basis, on the surface, is to allow the plan to credit the actual rate of return on the plan's investment portfolio.

It seems intuitive:

If participants receive what the plan portfolio earns ›
Risk of the employer having to cover market losses is minimized ›
Participants can benefit from long-term investment returns in a prudently invested portfolio ›
Costs are predictable ›
The business owners can consistently pay their fair share of contributions and costs, ›
The plan is easy to understand and explain to participants

The first two objectives, maximum tax deferred savings and competitive benefits at reasonable cost for our employees, can bring into play at least five separate nondiscrimination tests governing cash balance plans. Using the actual portfolio return can cause a failure of one or more of these tests when the asset performs well or poorly in a year. In addition, the steps necessary to make the plan pass testing can cause wide swings in annual contributions, cross-subsidies of costs among business owners, and benefit distributions to participants that aren't the same as their cash balance account.

Prioritizing and pursuing these first two objectives often leads to choosing either a fixed interest crediting rate that is between 3-5% or one of the fixed income indexes with perhaps a floor and/or a cap to avoid running afoul of the nondiscrimination tests in a given year. With this realization, the question arises, "Why should I set up and participate in a plan that can only credit a low rate of return when I can save on my own with a greater return?"

There are several compelling reasons:

- Most business owners achieve significant benefits from the long-term tax-deferral of their cash balance account growth. Our interactive tax illustrations generally prove that there are significant financial benefits over after-tax savings.
- The time horizon to retirement for the business owner can often be relatively short, and the fixed income-like growth of the cash balance account helps achieve a targeted retirement savings goal.
- Business owners can adjust their 401(k) account investments so that the cash balance plan becomes the fixed income portion of their aggregate retirement plan portfolio. Business owners can achieve the upside investment performance through their 401(k) plan and have partial protection against downside risk through the cash balance plan.
- The cash balance account can later be converted into a diversified long-term investment portfolio by distribution as a lump sum and rollover to an IRA.
- Cash balance plans have higher tax deductions than having a 401(k) plan alone.
- Cash balance plans serve as protection of assets from creditors.

In Perspective

When the IRS expanded their list of permissible interest crediting rates to include the actual portfolio return, there was a good amount of interest in implementing this intuitive approach. As we've come to understand, achieving all of the common objectives with a cash balance plan has caused the more conservative, fixed rate or fixed income index interest crediting rates to be the popular choice among our clients— at least to date. We will keep you posted on any new developments that can help you better achieve your objectives and enhance your plan.

	Permissible Interest Crediting Rates	**Permitted Floor**
Fixed Rate	Up to 6%	N/A
Inflation	CPI Index +3.00%	5% annual
Government Bond Rates and allowable margin	Yield on 3-month Treasury Bills +1.75% Yield on 12-month or shorter Treasury Bills +1.50% Yield on 1-year Treasury Constant Maturities +1.00% Yield on up to 3-year Treasury bonds, constant maturities, +0.50% Yield on up to 7-year Treasury bonds, constant maturities, +0.25% Yield on up to 30-year Treasury bonds, constant maturities	5% annual
Investment grade corporate bond rate	The first, second or third segment rates as defined by the IRS	4% annual
Investment-based rates	Actual rate of return of the portfolio Actual rate of return on a subset of the portfolio Actual rate of return on annuity contract Rate of return on certain regulated investment companies (RIC)	3% cumulative

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