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Using Rate of Return in Cash Balance Plans

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In this article, the author discusses the main issues he has encountered with clients using rate of return cash balance plans.

Way back in Spring of 2015 I wrote a column for the *Journal of Pension Benefits* regarding cash balance (CB) plans that use actual rate of return (ROR) on assets for their crediting rates—we'll call these ROR CB plans for the purposes of this article. Reader, it may be helpful to go back and read that column before you go any further! In this article I'll detail experiences from a few years of working on these plans.

Background

First, let's revisit why these plans are attractive for groups with multiple principals. The main attraction is the potential to mitigate against having to make up losses if the plan is underfunded (the contribution in a ROR CB is *usually* the amount of the annual credits), and try to avoid a situation where a principal exits while the plan is underfunded (as can happen when a plan uses a fixed crediting rate but then has investment losses) and the other principals are left holding the bag for those losses—we'll call those "stranded costs."

For reasons I outlined in detail in that earlier column, most plans that use actual ROR cap the ROR at some fixed rate, usually 5 or 6 percent. As a quick primer, the reason for this is because the Internal Revenue Service (IRS) requires that the projection forward to determine the accrued benefits for all testing purposes be at the current ROR for the year. Without this cap 401(a)(4) and 401(a)(26) testing becomes unstable, and 415 maximum lump sums become volatile. In a year with a high ROR the 415 maximum lump sum is significantly reduced. Capping the ROR at a maximum fixed rate avoids this issue.

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Some practitioners believe that Congress eliminated this issue for plan years after 2022 via the SECURE 2.0 Act. However, the language in Secure 2.0 only eliminates this issue for purposes of determining if a plan provides for impermissible backloading by capping the projection rate at 6 percent. It did not extend this change to all other testing purposes. While no one knows what guidance the IRS may issue in the future, I think Congress would have specifically changed it for other purposes if it intended to (and, in fact, that broader language was in an earlier version of the legislation), and I doubt we will see guidance on this for a long while. Therefore, unless and until we get guidance changing how these plans are tested, it is most prudent to continue using the longstanding projection rules.

With a decade of experience working on these plans, I'll discuss the main issues I have run into with my clients who use this design.

Issues Encountered

The first issue relates to the cap on the ROR when the investment return has exceeded the cap. Eventually a principal leaves the group and says "hey now, why doesn't my distribution amount allocate me a share of that higher return? It's my money too and I should get some of it'. How is that managed? The group can say "Tough bananas, this is how the plan works and this surplus is to protect against a downturn," but that usually doesn't go well and turns litigious if that situation hasn't been outlined in the shareholder/partner agreement. Or more commonly, an "ad-hoc" amendment is adopted to allocate the surplus to all the partners, to the extent it is allowed under the 415 limits, and of course this increase is subject to nondiscrimination testing.

The big issue for these plans only really hit in 2022 when almost every plan experienced significant investment losses, and these losses created the following first-time issues for these sponsors to address.

The first of these issues relates to satisfying the minimum participation requirement of Section 401(a)(26). The CB credit must be meaningful for at least 40 percent of the eligible participants (or 50 participants, if less). A meaningful benefit is a CB credit high enough to provide a benefit at retirement of 0.5 percent of compensation as a life annuity. In a year with an investment loss, a projection rate of 0 percent is used to determine that accrued benefit, and many of these plans needed significant additional CB credits provided by a corrective amendment in order to pass 401(a)(26) for 2022.

Ok, but it's simple, they can go ahead and increase the CB credits to the highly compensated employee (HCE) participants in the corrective amendment, right? Not so fast! Many ROR CB plan were designed to cover HCEs only, and the CB plan is of course tested together with a profit-sharing plan that covers non-highly compensated employees (NHCEs). The corrective amendment regulations specify that a corrective amendment must be provided to a group that passes 410(b) in a manner that passes 401(a)(4). Increasing the credits to the HCEs in the CB plan clearly would not satisfy this requirement, which then necessitates bringing NHCEs into the plan, which is problematic when the plan was sold as a plan that covers HCEs only.

The second issue relates to the preservation of capital rule, which is a statutory requirement for these plans. Under this rule, upon distribution a participant can never be paid less than the cumulative amount of their credits. For example, assume Dr. Smith entered the CB plan in 2021 and had a 2021 and 2022 CB credit of $100,000. In 2022 the ROR was a negative 20 percent, so on 12/31/22 Smith's CB account is $180,000. Smith then terminates in January of 2023 and wants to be paid out, but the plan cannot pay Dr. Smith less than $200,000. So even though this plan used actual ROR to try to mitigate against "stranded costs," there will be an investment loss to the plan in 2023 of $20,000 that must be made up by the practice. Hopefully that group has language in their shareholder/partner agreement to address that Smith must pay the group $20,000, or have their buyout adjusted in some manner to adjust for this situation.

What also compounds this situation is the trend for these plans to allow in-service distributions after age 59½ (because every doctor is smarter than the professional investment advisor for the plan and they want to control their own money). In these plans, it is common for every principal/shareholder over 59½ to request an in-service distribution of their CB credit for the year immediately after year end. But under the Preservation of Capital rule, they'd have to be paid the full credit without the impact of the loss on that credit, and that triggers an investment loss. The ways this can be managed are:

- As an understanding among the principals/shareholders they don't take any in-service distributions if the preservation of capital rule would apply,

but this doesn't make those principals very happy and the plan cannot deny a distribution request if someone requests the distribution.

- Have language in the shareholder/partner agreement that requires them to pay the practice for the shortfall between their CB account and the amount they have to be paid out under the Preservation of Capital rule if they request an in-service distribution.
- As an understanding among the principals/shareholders, they request only a partial distribution of maybe 75 percent of their actual CB account in any year in which the Preservation of Capital rule would apply. This gives the principal most of their money, avoids the triggering of the preservation of capital rule in that year and leaves some funds to recapture losses, but then requires a complicated tracking to ensure that over time they have never been paid less than their preservation of capital rule amount.

Conclusion

I'm going to end this article in the exact way I ended the 2015 column: Using ROR as the interest crediting rate is a useful tool for a specific set of design objectives for a specific client. As with any other tool, it is important to understand how it should be used properly. I hope this article helps a bit in understanding its usefulness and limitations. ■

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