AMERICAN ACADEMY *of* ACTUARIES

May 24, 2011

Mr. Harlan Weller
Government Actuary
U.S. Department of the Treasury
Suite 4028
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Ms. Carolyn Zimmerman
Actuary
Internal Revenue Service
SE:T:EP:RA:T:A2
1000 Liberty Avenue
Room 711
Pittsburgh, PA 15222

RE: Expected regulatory guidance on "plan-related expenses" under the Pension Protection Act of 2006 and the Worker, Retiree, and Employee Recovery Act of 2008

Dear Mr. Weller and Ms. Zimmerman:

The American Academy of Actuaries[1] Pension Committee would like to express its views regarding the potential implications of expected regulatory guidance on the definition of "plan-related expenses expected to be paid from plan assets" under Internal Revenue Code (IRC) Section 430(b).

We understand that upcoming guidance may include "investment-related expenses" in addition to "administrative expenses" as part of the Section 430 calculations, which is a significant concern to the actuarial community. As you may recall, an unscientific poll conducted at Session 803 of the 2011 Enrolled Actuaries Meeting indicated that a majority of actuaries prepare Section 430 calculations in good faith by including "administrative expenses" as plan-related expenses, while excluding "investment-related expenses."

Summary

The Pension Protection Act of 2006 (PPA), as amended by Section 101(b)(2) of the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), requires "plan-related expenses expected to be paid from plan assets" to be added to the target normal cost under IRC Section 430(b) in the development of contributions for single-employer defined benefit pension plans. As noted above, we understand that the Internal Revenue Service (IRS) is currently drafting—but has yet to issue—formal guidance that specifically would identify these plan-related expenses to permit the plan's enrolled actuary (EA) to quantify the amount for compliance with the statute. In addition, the Department of Labor (DOL) has issued both a final regulation and an interim final regulation (IFR) detailing definitions of plan-related expenses for tax-qualified retirement plans.

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[1] The American Academy of Actuaries is a 17,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

This letter discusses plan-related expenses for defined benefit pension plan calculations, and raises associated issues EAs may have encountered since PPA regulations were issued.

Background

PPA generated the need for much regulatory guidance on the calculation of pension liabilities and asset valuation methods to develop the minimum required and maximum tax-deductible contributions for single-employer defined benefit pension plans.

WRERA provided certain technical corrections to PPA and associated PPA funding relief. Technical corrections in WRERA included the clarification of the calculation of the actuarial value of assets under IRC Section 430(g)(3)(B) to allow for smoothing of asset returns and an amendment to the definition of target normal cost. Target normal cost now requires the addition of a dollar amount to pay for the *"…amount of plan-related expenses expected to be paid from plan assets during the plan year"* (Section 101(b)(1)(A)(ii) of WRERA). "Plan-related expenses" is not defined in final PPA regulations (issued in October 2009) and Section 1.430(d)–1(b)(1)(iii)(B) is reserved for that definition.

It is commonly believed that WRERA was meant to target only administrative—not investment—expenses. A clarification (via a change to "plan-related *administrative* expenses") was included on a list of technical corrections drafted and introduced in bills by lawmakers several times in 2009 and 2010. Although this technical correction is not currently included in any legislation, the previously proposed corrections speak to the need for clarification.

In a separate point, we refer to DOL final regulations published in November 2007 as its set of regulatory overhaul rules affecting fee transparency and disclosure in tax-qualified retirement plans. These rules amended certain disclosures on Form 5500, as well as the definition of compensation (i.e., fees or expenses) paid from the plan and reported on Schedule C. DOL published an IFR in July 2010 for ERISA Section 408(b)(2) (29CFR 2550.408b-2) that will be effective for plan years starting after Dec. 31, 2011. In the July 2010 IFR, DOL defined "covered service providers" as those receiving compensation from plan assets in administrative, fiduciary, brokerage, and advisory roles to a tax-qualified pension plan.

Discussion

There are several issues that EAs have considered while waiting for further guidance from the IRS on the specific components of "plan-related" expenses, including those discussed below.

Consistency with actuarial value of assets (AVA) calculation under IRS Notice 2009-22

IRS Notice 2009-22 states: "*...the adjusted fair market value of assets...is the fair market value of plan assets, increased for contributions…, and decreased for benefits and* ***administrative expenses*** *paid from plan assets" (**emphasis added).***

We believe that it is appropriate to ensure consistency between the expenses used in the AVA calculation and those used as "plan-related expenses" added to target normal cost. A review of the calculation requirements in Notice 2009-22 has led many EAs to conclude the reasonable interpretation is that the explicit subtraction of "administrative expenses" in the AVA calculation is an indication that final guidance by IRS will validate administrative expenses as the appropriate load

to target normal cost. An expected return on the AVA, therefore, should be net of expected investment expenses, but should disregard the effect of administrative expenses. Since the return on plan assets is being used to pay for plan-related benefits and administrative expenses, it is reasonable to assume that the contribution to the plan reflects the same amounts so that the expense load **excludes investment expenses**. (We acknowledge that the expected return used in the AVA calculation can be no higher than the third segment rate of the IRS default yield curve.)

Requirement that expenses be paid from plan assets

The definition of "plan-related" expenses in WRERA specifically indicates that the expenses must be amounts "expected to be paid from plan assets." In general, administrative expenses involve an external service provider sending an invoice to the plan sponsor/administrator, which is then submitted to the trust and **paid by plan assets**, often via check, electronic transfer, or other means. PBGC premiums, which also would constitute administrative expenses, are paid in a similar manner. Most investment-related fees, however, generally are netted against investment returns credited to the plan by investment managers. As a result, most investment-related fees may not be separately identified or disclosed in the trust statements, since the plan was not directly invoiced for services to be paid from plan assets.

Therefore, an actuary might reasonably assume that "plan-related" expenses generally do not include investment expenses. The actuary also may assume that "plan-related" expenses to be added to the target normal cost are based on expenses disclosed on IRS Form 5500, Schedule H, Part II, Section i, Lines (1) and (2) in the prior plan year, as adjusted for changes in expectations for the current plan year. Line (1) is for professional fees (actuaries, accountants, ERISA counsel, etc.) and Line (2) is for contract administrator fees.

Investment expenses are part of investment return

From a theoretical point of view, limiting the target normal cost adjustment to administrative expenses would appear to be the more correct approach. Investment-related expenses are incurred in the process of generating investment return. Plan sponsors can elect passive or active management of investments, with the latter generating higher investment expenses. Although active management is no guarantee of higher returns, the primary reason that a sponsor would elect active management is in expectation of generating higher returns. It is reasonable, therefore, to expect that the net long-term costs incurred by a sponsor of a plan using active management may be no higher (and potentially even lower) than that incurred by a sponsor using passive management. The sponsor of the actively managed plan should not be forced to pay *more* up front and then recover the higher returns over future years as the investment gain is amortized. Rather, both sponsors should have the same target normal cost. To the extent that active management does not, in some years, justify the extra expense, the resulting loss would be amortized (as would the gain resulting from outperforming passive management).

Difficulties collecting estimated investment expense information

As currently is being demonstrated in response to the DOL's rules, collection of ***all*** investment expenses to report in the future is more difficult than collecting the direct expenses for Schedule H. The "direct" investment expenses on Schedule H are likely only to be a subset—and sometimes, a very small piece—of all investment expenses of the pension plan. While those "direct" investment expenses are payable from the plan assets and are disclosed explicitly, they do not include the

additional "indirect" expenses (DOL November 2007 final rule) that are paid to covered service providers (DOL July 2010 IFR), which usually are expressed as a percentage of plan assets, or sometimes as a percent of return.

Starting with plan years in 2009, indirect compensation was supposed to be disclosed on Form 5500 Schedule C. But there have been numerous issues associated with capturing the amounts of these fees, including:

> 1) Many covered service providers elected a statutory exemption to the requirement to report indirect expenses for 2009 plan years by issuing a letter to the plan administrator that they cannot comply for certain valid reasons (the exemption ends after the 2009 plan year).
>
> 2) The covered service provider may receive indirect compensation under an alternative method in which payment of "eligible indirect compensation" is authorized in advance by the plan sponsor. Eligible indirect compensation must be disclosed in a written contract to the plan administrator from the covered service provider. With the classification of these expenses as eligible indirect compensation, there is no requirement for these expenses to be disclosed on Form 5500 Schedule C.

In other words, information on two primary sources of fee disclosure on plan investments may be difficult to collect or not available to quantify.

We make no presumption that the DOL will extend the exemption of indirect expense disclosure beyond plan year 2009. We propose it may be reasonable for an EA to base the expectation of plan-related expenses on information provided to the plan administrator. There are still obstacles, many of which are complex. There are some investment expenses that are not reported to the administrator.

Investment purchases and sales within the pension trust regularly generate three types of transaction costs:

- Commissions
- The buy/sell spread
- Market impact

Commissions generally would not be reported if the underlying investment were a no-load mutual fund. While the mutual fund would have expenses, returns on no-load mutual funds generally are reported net of all expenses and the amount of the expenses is not reported to the plan administrator. This may not be the case, however, for pooled or trusteed investments in which commissions are reported to the plan administrator. Differentiating investments in mutual funds from other types of pooled or trusteed investments is unlikely to provide any incremental value in the assessment of the net investment return.

Regarding the buy/sell spread and market impact, these two costs are not reported to the plan sponsor, and are virtually impossible to calculate with any level of precision. These investment expenses, therefore, will be difficult to include as plan-related expenses.

Timing may also be a key issue, as was demonstrated in the 2009 Form 5500 electronic filing season that ended on Oct. 15, 2010. How much time will elapse between the request of the information and

the receipt of it, and will that information be complete and available to meet the accelerated valuation timing to which many plans are now subject?

Conclusion and Request to IRS

EAs wish to comply fully with the rules related to the "plan-related expenses" load to target normal cost for PPA funding calculations. In the absence of formal guidance from the IRS, many EAs relied on historical practice as well as the use of administrative expenses required to be used in the Notice 2009-22 calculation of the AVA as a guide. In practice, we believe this is the approach that most actuaries have used and disclosed on Form 5500 Schedule SB.

It is likely that such administrative expenses would be consistent with the values posted on Form 5500, Schedule H, Part II, Section (i), Lines (1) and (2). This is also consistent with DOL rules which, in many cases, do not require public disclosure of investment-related fees, as in the case of fees that are classified as "eligible indirect compensation." IRS guidance ultimately may—and arguably should—reflect this interpretation.

If the formal IRS guidance requires the inclusion of investment-related expenses in the target normal cost, we respectfully request prospective application only, as there would be considerable effort in restating prior plan year results. It would not be surprising if defined benefit plans, particularly those with adjusted funding target attainment percentages (AFTAPs) at or near 80 percent, would no longer be in compliance with IRC Section 436 benefit restrictions. In addition, unpaid minimum required contributions may result.

The Pension Committee appreciates your consideration of these comments and would be happy to discuss them with you at your convenience. Please contact Jessica M. Thomas, the Academy's senior pension policy analyst (202-785-7868, thomas@actuary.org) if you have any questions or would like to discuss these items further.

Sincerely,

John H. Moore, FSA, MAAA, EA, FCA
Chair, Pension Committee
American Academy of Actuaries