AMERICAN ACADEMY of ACTUARIES

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Room 4024
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Internal Revenue Service
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RE: Merger and Spinoff Issues Regarding Measurement of Assets and Liabilities for Pension Funding Purposes and Funding Ratios

Dear Mr. Weller and Mr. Zuckerman:

The American Academy of Actuaries[1] Pension Committee respectfully requests your consideration of its comments and recommendations for future guidance on merger and spinoff issues related to the measurement of assets and liabilities for pension funding purposes and funding ratios. The final Internal Revenue Code (IRC) Sections 430 and 436 regulations[2] reserve places for guidance on these issues.

The principal difficulties that should be recognized and addressed in future guidance are:

- The benefit restriction rules effectively require that a plan's adjusted funding target attainment percentage (AFTAP), presumed or certified, be determinable immediately following a merger or spinoff in order to properly administer the plan;

- The transactions that result in mergers and spinoffs frequently do not occur on the last day of the plan year of the affected plans;

- The enrolled actuaries for the affected plans often do not work for the same firm, which introduces delays in communication and coordination;

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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.

[2] http://www.gpo.gov/fdsys/pkg/FR-2009-10-15/html/E9-24284.htm

- And, in the case of spin-offs, the required division of assets in accordance with Section 414(l) is difficult, time-consuming, and of necessity always completed after the effective date of the spinoff.

We are suggesting several specific alternatives to address the issues raised by mergers and spinoffs. These suggestions are based on our overarching principles that any rules governing mergers and spinoffs should:

- Provide specific guidance on how to handle most situations that might arise and principles that could be applied to other situations;
- Provide a workable approach given the timing and data constraints that often accompany these transactions—particularly spinoffs;
- Make use of available valuation results to the extent possible so that results may be computed and verified easily, especially for any interim period measurements; and
- Limit opportunities to manipulate results to achieve outcomes that are inconsistent with the Pension Protection Act (PPA) benefit restriction and funding rules.

While we have tried to consider the different possibilities that might arise, we realize it is likely our suggestions do not cover all possible situations. We believe it is important, nevertheless, that the Internal Revenue Service (IRS) issue guidance in the near future to help alleviate the uncertainty that currently accompanies these transactions. For this reason, we believe it would be helpful for any initial guidance to set forth rules that can be relied upon immediately and that are as specific as possible. These rules, however, should stipulate that a reasonable interpretation of this guidance and its underlying principles may be applied to situations that do not fit exactly into the fact patterns covered unless and until addressed by subsequent guidance.

For your convenience, we present separate sections on mergers and spinoffs, although many of our comments and recommendations overlap. Within each section, we discuss minimum funding, funding target attainment percentage (FTAP) (Section 430), and AFTAP (Section 436) issues.

Plan Mergers—Minimum Funding Requirements

We believe that regulations governing the funding rules for plan mergers should follow the general principles as outlined in Sections 4.05 through 4.08 of IRS Revenue Procedure (Rev. Proc.) 2000-40 and the guidance for short plan years from applicable PPA funding regulations. For mergers that do not have a transition period of more than 12 months, the calculations and concepts are relatively straightforward. Mergers with different plan years require additional considerations in applying funding balances to the pre-merger and post-merger periods.

Mergers occurring on the first day of the plan year for the disappearing plan should be treated in the same manner as a merger occurring on the last day of the preceding plan year.

Following the methodology of Rev. Proc. 2000-40, the PPA rules for plan mergers can be broken into four primary situations: (1) *de minimis* mergers, (2) mergers with the same plan year and a merger date of the first or last day of the plan year, (3) other mergers with a transition period of no more than 12 months, and (4) other mergers with a transition period of more than 12 months.

***De minimis* mergers**

Funding calculations should follow the same rules as described in Section 4.05 of Rev. Proc. 2000-40. For the period from the beginning of the plan year of the small plan through the date of the merger, the small plan would follow the rules applicable to short plan years (including any applicable quarterly funding requirements for the short plan year) as described in proposed regulations 1.430(a)-1 and 1.430(j)-1 (or subsequent final regulations, if changed). Any contributions made for the smaller plan after the date of the merger, but not later than eight and a half months after the date of the merger, are credited to the smaller plan and reported on the Schedule SB for the smaller plan.

For purposes of the funding calculations, the larger plan would ignore the smaller plan until the valuation date coincident with or next following the date of the merger. The funding methods (including the PPA interest rate methodology and asset method) used for the larger plan would continue. Any shortfall amortization bases, funding balances, or unpaid minimum required contributions with respect to the small plan are disregarded for purposes of applying Sections 430 and 4971.

Mergers with same plan year and merger date of first or last day of plan year

If the date of the merger is the first day of the plan year, the minimum funding rules of Section 430 are determined for the merged plan for the entire plan year. There is only one Schedule SB filing for the merged plan. The funding methods, PPA interest rate method, and asset method used by the ongoing plan are continued after the merger. The ongoing plan is the plan so designated by the plan sponsor. The methods used by the noncontinuing plan are disregarded. This approach offers the same flexibility as was inherent in Rev. Proc. 2000-40. If there is a concern, however, that this rule could be manipulated by merging a large plan into a small plan, one option would be to require use of the larger plan methods whenever the larger plan comprises some percentage (e.g., 75 percent) of the combined funding target liabilities.

Any shortfall amortization bases that were being maintained by the two plans continue to be maintained for the merged plan unless they would be considered fully amortized based on the merged plan’s funded status. Any funding balances are brought forward separately for each plan to the beginning of the plan year—using the individual plan effective interest rate (EIR) and asset returns, as applicable—and then combined. Prefunding balances (PFB) may be created for either of the plans related to the excess contributions for the prior year for that plan. Funding balances would retain their pre-merger character (carryover balance (COB) or PFB) and, once merged, the COB of the merged plan would be used or forfeited before any of the PFB could be used or forfeited. The character of funding balances used or forfeited before the merger date, however, would not be affected by the merger. For purposes of calculating the value of assets, historical asset values and cash flows for the plans would be aggregated for each measurement period.

If the date of the merger is the last day of the plan year, the funding requirements are determined for each plan without regard to the merger. Separate Schedules SB are filed for each plan. Any timely contribution made for the plan year but after the date of the merger may be credited on either of the Schedules SB. For the plan year following the date of the merger, the minimum funding rules are determined, as previously recommended, as if the merger were on the first day of the following year.

"Lookback" calculations are used for certain purposes, such as determining quarterly contribution requirements, ability to apply funding balances, and at-risk status. For these purposes the separate prior year components simply would be added together to determine the applicable combined funded ratio or amount, ignoring any differences in assumptions or methods. Prior year assets would be added together after application of the 90 percent to 110 percent corridor around smoothed asset values (if applicable).

In addition, the approach for determining safe harbor quarterlies in Q&A No. 5, Part (e) in the 2004 Gray Book could be established as an alternative for this situation in which the prior-year amount for the plan that is not continuing is redetermined based on the assumptions and methods used for the continuing plan in the prior year. This should be allowed as an option, however, and not be a requirement, due to the potential additional work involved and delays in receiving accurate data.

Mergers with transition period of no more than 12 months

For a non-*de minimis* merger with a transition period of no more than 12 months, for which the merger date is not the first or last day of the plan year or the plan years are not the same, the minimum required contribution (MRC) for the disappearing plan will have to be adjusted and may have to be split between the pre- and post-merger periods. In cases in which the ongoing and disappearing plans have different plan years, the disappearing plan effectively will have a short plan year, which ends on the last day of the ongoing plan's plan year. Pre-PPA automatic approvals ensured that the sum of the MRCs for the plans involved would be equal to the sum of the contributions for the two plans in the absence of the merger and for which the MRC for the disappearing plan would be adjusted for the short plan year.

We believe that there are two ways to allocate the short plan year MRC for the disappearing plan between the pre- and post-merger periods:

1) Allocate the MRC components for the disappearing plan on a pro rata basis between the pre- and post-merger periods;

2) Treat the pre-merger period as a short plan year as well, in which case the post-merger MRC components would be the difference between two short plan year calculations.

We believe that the first of these approaches would be easier to administer and, therefore, would be preferable.

The short plan year valuation for the disappearing plan for the period ending on the last day of the ongoing plan's plan year would follow the rules for adjusting the minimum funding requirements (including applicable quarterly funding requirements for the short plan year) as described in proposed regulations 1.430(a)-1 and 1.430(j)-1 (or subsequent final regulations if changed). The target normal cost (TNC) and shortfall amortization amounts then would be allocated on a pro rata basis to the pre- and post-merger periods.

Quarterly contributions in the year of the merger
The quarterly contribution schedule, in the aggregate, would be adjusted as for a short plan year. The due dates for all quarterly contributions occurring before the end of the ongoing plan's plan year would remain unchanged. The final quarterly contribution would be due on the same date as the final quarterly contribution for the ongoing plan. The amount of each quarterly contribution would be reduced, if appropriate, as would be the case for a short plan year. Quarterly contributions made before the merger date would, of course, be allocated to the disappearing plan. Quarterly contributions made after that date, but before the final contribution due date for the disappearing plan, could be allocated to either plan. Since the payments would end up in the same trust, there would not appear to be any benefit to being overly prescriptive about how these amounts are allocated. We suggest that the default approach would be to allocate payments to the disappearing plan until the MRC for that plan has been satisfied and then allocate the remainder to the combined plan. The sponsor should have the discretion, however, to modify this allocation, if desired.

Applying, creating, or waiving funding balances in the year of the merger
Funding balances for the disappearing plan would be available to apply to the merged plan on or after the merger date, to the extent they are not used by the disappearing plan for the pre-merger period or prior plan year, as applicable. Any prefunding balance created for the disappearing plan related to the pre-merger period would carry forward to the merged plan, and would be available for the merged plan to apply and/or waive following the date it is created in accordance with the general funding balance chronology rules. If two calendar year plans merge on July 1, 2011, for instance, any unused Jan. 1, 2011, funding balance for the disappearing plan would be added to the Jan. 1, 2011, funding balance for the continuing plan. Any PFB created for the 2011 pre-merger plan year of the disappearing plan would be determined as of Jan. 1, 2011, and would be added in to the funding balances of the ongoing plan (i.e., rather than being added at the beginning of the following plan year with some combination of EIR and asset returns applied), to be available for use/forfeiture in the post-merger period. This approach would provide a mechanism for applying excess contributions for the short plan year to the post-merger period and is consistent with what would have been permitted in the absence of a merger.

For plans with different plan years, the amount available in the ongoing plan would be adjusted based on the EIR for the ongoing plan to the first day of the plan year for that plan. Ordering rules for the use and reduction of funding balances may be needed because the balances from the different predecessor plans may be treated slightly differently and because separate AFTAPs and FTAPs for each of the predecessor plans may have to be determined. COBs would continue to be used before PFBs. If a plan with a COB is merged into a plan with only a PFB, the first post-merger election to apply balances would draw first on the COB that came with the plan being merged in. When there is a choice between which plan's COB or PFB is being used, there is no clear logic for designating one plan or another to be used first. One option would be to allow the sponsor to designate an order. Another option would be to specify an order—e.g., first use the balance of the ongoing plan, then use the balance of the plan(s) being merged in order of merger. For multiple plans merged in on the same day, an arbitrary designation might be required—e.g., apply balances in descending order of magnitude of assets being merged in. Having an automatic designation will allow the rules to be reapplied automatically if a subsequent reduction in funding balance eliminates a portion of funding balance that otherwise would have been applied.

For cases in which the sponsor is electing to reduce a funding balance, the sponsor should be allowed to designate from which predecessor plan the balance is coming. This will allow the sponsor to adjust the pre-merger AFTAP or FTAP, as necessary. Consider a plan, for example, with both a COB and PFB merging into a plan with only a PFB. After the date of the merger, the sponsor decides to reduce the PFB of the ongoing plan to improve the pre-merger FTAP of that plan. The sponsor should be permitted to designate that the reduction is coming from the PFB of that particular plan without first having to fully reduce the COB that came from the plan being merged, as the same election would have been permitted had the sponsor made it before the merger date.

In bringing any unused amounts from the disappearing plan forward during the year, interest would be based on the continuing plan's EIR up to the first day of the disappearing plan's plan year and then would be based on the combined rate of return on assets from that point forward.

For the disappearing plan, this approach effectively splits a single plan year into two pieces. Although there is a single valuation date, contribution requirements and funding balance creation and application rules apply separately with respect to each piece. If excess contributions are made for the pre-merger short plan year, the sponsor may elect to create a prefunding balance that can then be applied against the minimum funding requirement for the merged plan. As this prefunding balance is created within the same "valuation year" and not a previous year, certain special considerations would apply to the portion of the PFB that results from excess contributions for the short plan year. This portion:

- Is disregarded in determining the combined FTAP / AFTAP for the merged plan; and

- Can be applied to the post-merger period without regard to the prior year FTAP, since these would represent contributions within the same valuation year.

The ordering rules for using or reducing funding balances would apply as if the pre-merger period and post-merger period were part of the same plan year, but with several adjustments:

- Funding balances applied against the MRC for the pre-merger period cannot be retroactively undone by a deemed or elective waiver of balances during the post-merger period. It still can be undone by a deemed or elective waiver of balances during the pre-merger period.

- The deadline for elections to reduce balances for the actual short plan year (i.e., the pre-merger period) is the earlier of the end of the post-merger plan year or the final contribution due date for the short plan year.

- The funding balances acquired by the continuing plan from the disappearing plan retain their classification of PFB or COB so that the continuing plan may have remaining COB in the post-merger plan even though it applied a PFB against the MRC pre-merger.

- The use of a PFB against the MRC by the disappearing plan would not trigger the requirement to remove the PFB from assets in determining whether the ongoing plan was exempt from establishing a shortfall amortization base.

Following year valuation for ongoing plan
If the merger date is the first day of the current plan year for the ongoing plan, there is no interim period. As a result, the funding balances for the individual plans are brought forward using the EIR and actual asset returns for each plan separately and then are combined as of the beginning of the plan year of the ongoing plan. Prefunding balances may be created for either of the plans related to the excess contributions for the prior year applicable to that plan. Any shortfall amortization bases that were being maintained by the two plans continue to be maintained for the merged plan (including any applicable adjustments for those balances related to the short plan year of the disappearing plan) unless they would be considered fully amortized based on the merged plan's funded status.

If the merger date is the last day of the plan year for the ongoing plan, then there is also no interim period. Funding balances, amortization bases, etc., are treated the same way as in the preceding paragraph, as though the merger occurred on the first day of the following plan year.

For any other merger date, there is an interim period. For the next valuation date of the ongoing plan, the treatment of shortfall amortization bases, funding methods, etc., is as above. Ignoring the effect of changes in quarterly contribution schedules or other differences, if the same amount of funding balances were applied, there should be no significant difference in the ending funding balance if the plan merger instead had occurred on the last day of the plan year of the ongoing plan, except for any differences in actual asset returns due to the merger.

The funding methods, PPA interest rate method, and asset method used by the ongoing plan are continued after the merger. The methods used by the disappearing plan are disregarded. In a case in which the plan designated as the ongoing plan is much smaller than the plan being merged in (e.g., less than 25 percent of the funding target of the post-merger plan), it might be appropriate to consider an anti-abuse rule that would specify continued use of the methods used by the larger plan.

Quarterly contributions in the year following the merger (or year of the merger if the merger is on the first day of the plan year for the ongoing plan)
If the merged plan has a shortfall for the year of the merger (or year preceding the merger if the merger is on the first day of the plan year for the ongoing plan), determined as the sum of the funding targets, less the sum of adjusted assets (assets reduced by funding balances) for such year, then the merged plan is subject to quarterly contributions in the following year. The determination of the applicable quarterly amount is 90 percent of the current year MRC, or 100 percent of the prior year MRC. This is ratably adjusted, if necessary, to reflect a 12-month plan year for the plan that disappeared as a result of the merger, if a full 12 months was not included for that plan between the disappearing plan and the amount added to the continuing plan's MRC—i.e., if the plan years were not the same. We believe it is important to provide a lookback rule in this situation even though one of the pre-merger plans may have had a short plan year.

Other lookback determinations
For purposes of determining the ability to apply funding balances, at-risk status, or any similar applicable "lookback" liability, asset or funded percentage, the separate prior year components simply would be added together to determine the applicable combined funded ratio or amount, ignoring any differences in assumptions or methods. Prior year assets would be added together after application of the 90 percent to 110 percent corridor around smoothed asset values, if applicable.

Mergers with transition periods of more than 12 months
In the case of a non-*de minimis* merger for which the transition period is longer than 12 months (i.e., plans are merged with different plan years and the next plan year end for the ongoing plan is after the next plan year end for the disappearing plan), additional adjustments need to be made for the interim period, but otherwise the funding rules should be similar to those for mergers with a transition period of not more than 12 months. An additional adjustment may be made for the portion of the interim period that extends beyond what would have been the last day of the plan year of the disappearing plan had no merger occurred.

There are a number of possible approaches that balance simplicity with a concern for relying on results that are too outdated. The simplest approach would be to extend results for the disappearing plan for more than a year, without any adjustment for changes in assumptions or gains or losses in the interim. This approach may be appropriate in at least some circumstances, including:

- The transition period does not extend far beyond 12 months (e.g., 15 months);

- The disappearing plan is sufficiently small relative to the ongoing plan (e.g., funding target less than 50 percent of the funding target of the ongoing plan prior to the merger);

- The existence of some combination of these or other factors.

Another option would be to follow the approach used in Rev. Proc. 2000-40, in which the only additional adjustment would be to establish a shortfall amortization base for asset gains or losses. Rev. Proc. 2000-40 determined this base using market value of assets. We believe it would be more appropriate, however, to calculate this base as the difference between the expected value of plan assets and the actual value of plan assets, calculated as if the merger date was a measurement date. If the disappearing plan had been exempt from establishing a shortfall amortization base, then the exemption would continue. As an alternative, the exemption could be continued under more limited circumstances. The test for the amortization base exemption for the portion of the transition period that extends beyond 12 months, for example, could be applied on the last pre-merger valuation date by subtracting the asset loss from the value of plan assets on that date.

We note, however, that when Rev. Proc. 2000-40 was promulgated, valuation interest rates typically did not change year-to-year, so capturing assets gains and losses when the valuation grew too stale seemed appropriate. Now that interest rates also change from valuation date-to-valuation date, and the effect of these changes may offset some or all of the asset gains or losses, it no longer may be appropriate to make an adjustment for asset gains and losses in isolation.

Another option would be to redetermine values for the disappearing plan as of the merger date on a simplified basis:

- Assets can be calculated precisely and would include any contributions to the disappearing plan for the plan year prior to the merger (including those made after the merger date), as well as contributions made to the disappearing plan for the plan year of the merger made on or before the merger date.
- Carryover and prefunding balances would reflect all funding balance elections made by the merger date, and would be adjusted further by any subsequent election to apply balances to the prior plan year or an election to reduce or create balances as of the beginning of the year in which the merger occurs—but not by subsequent elections to apply balances to the current year.
- Liabilities could be determined based on the interest rates and mortality assumptions that would have applied had the merger date been a valuation date but calculated on the last actual valuation date for the disappearing plan and then rolled forward based on the EIR and adjusted to reflect actual benefit payments. Amendments or unpredictable contingent event benefits that were not reflected in the initial valuation would have to be included in this revaluation.
- If the merger occurs during the first nine months of a plan year for the disappearing plan and the valuation has not yet been completed, a presumed funding target based on the presumed AFTAP may be used in place of the rolled forward funding target. The presumed funding target could be used until the end of the ninth month after the valuation date of the disappearing plan. If the presumed funding target is scheduled to decline by 10 percent (generally on the first day of the fourth month after the valuation for the disappearing plan), the presumed funding target would be redetermined based on the reduced AFTAP. Whether the 10 percent reduction applies would be based on the combined

AFTAP/presumed AFTAP of the merged plan. Note that the use of a presumed funding target can produce results that are far out of line with the actual results and so may not be appropriate.

As another option, a new valuation of the disappearing plan as of the ongoing plan's valuation date or the day before the merger date could be permitted, but should not be required.

Quarterly contributions due for the year of merger
Consistent with the recommendation for mergers with shorter transition periods, post-merger required contributions generally should not be affected by the merger. Quarterly contributions, if any, therefore would continue to apply to the extent that they would have applied for any pre-merger plan(s).The only difference in this case is that there is a transition period that goes beyond the period for which quarterly contributions otherwise would be defined for the disappearing plan. One option would be to make an adjustment similar to the short plan year adjustment—but in reverse. The quarterly contribution requirement would continue to apply, but an additional quarterly contribution due date would be added for each quarter (or part thereof) beyond 12 months. Consider a plan, for example, with a Nov. 1 plan year merging into a calendar year plan on July 1. The resulting transition period is 14 months. This means there would be five quarterly contributions. The amount of each contribution would be determined as 14/12 * 4/5 of the quarterly contribution that otherwise would have been required in the absence of a merger. The due dates would be Feb. 15, May 15, Aug. 15, Nov. 15 and Jan. 15. If the disappearing plan was exempt from quarterly contributions, then no such contributions would be due on account of that plan after the merger.

Quarterly contributions for the year following merger
Application to quarterly contributions in the following year is more straightforward. If the combined plan has a shortfall—determined as the sum of the funding targets less the sum of adjusted assets (assets reduced by funding balances) for the year in which the merger occurs for the affected plans—then the combined plan would be subject to quarterly contributions for the following plan year. The combined plan otherwise would be exempt.

Plan Mergers—Funding and Benefit Restriction Ratios

We recommend that relevant ratios be determined by adding together the components from the predecessor plans, without adjustment to harmonize assumptions, methods, or valuation dates. In determining the AFTAP and FTAP, the following components for each plan would be determined specifically as of the valuation date coinciding with or preceding the merger for each of the plans. The values would be added together to determine the resulting ratios for the combined plans:

- Value of plan assets (after application of the 90 percent to 110 percent corridor if applicable)
- Funding target
- Carryover balance

- Prefunding balance
- Annuity purchases for non-highly compensated employees.

For purposes of determining the presumed AFTAP for the post-merger period, AFTAP components for the year preceding the merger generally would be used. From a practical point of view, it may be difficult to make the necessary adjustment to plan administration beginning on the date of the merger. We therefore recommend a three-month grace period during which administration of benefits could continue to follow the administration rules for each piece of the plan that would have applied in the absence of a merger.

Mergers occurring on the first day of the plan year for the disappearing plan should be treated in the same manner as a merger occurring on the last day of the preceding plan year for that plan. The next valuation would be the valuation date for the ongoing plan. The proposed approaches discussed below assume that all plans involved in the merger use a beginning-of-year valuation date. In the case of the merger of multiple plans, the rules described below would be applied as a series of mergers of two plans, where applicable.

As discussed above in the minimum funding requirements section, for cases in which a merger has a transition period of more than 12 months, some components of the funding ratio may be too old to rely on. The approach used to determine funding ratios in this situation should be consistent with the approach used to determine valuation results. But an alternative approach may be needed, at least for some period of time, to allow for continued plan administration prior to the calculation of adjusted valuation results.

For certain calculations involving a prior year lookback (e.g., requirements to make quarterly contributions, at-risk, and 4010 for year of merger), we suggest that no adjustment be made for the disappearing plan for which there is a transition period of more than 12 months. If the time lag is a concern, another option could be that if calculations are brought forward to a later date for the plan that otherwise would have a transition period of more than 12 months (effectively treating results as of that later date as current year results for purposes of the merged plan), then results as of the actual valuation date prior to the merger would be treated as if they were prior year results for purposes of this calculation.

FTAP determination

Similar principles would apply to other measures. The prior year FTAP would be redetermined upon the merger based on the combined prior year funding target, assets and carryover, and prefunding balances of the plans. The current year FTAP would be based on the combined current year results of the two plans. As discussed above, special rules could be applied for cases in which there is a transition period of more than 12 months.

AFTAP determination

Similar principles would apply to the AFTAP calculations for the year of the merger. It is possible that one of the plans involved in a merger might have a certified current year

AFTAP, while the other plan relies on the presumption rules. Until the current year AFTAP is certified for the other plan, the combined AFTAP may be calculated using the presumed funding target based on the presumed AFTAP for the plan lacking a current year certification. As suggested above for mergers with a transition period of less than 12 months, we recommend a three-month grace period during which administration of benefits could continue to follow the administration rules for each piece of the plan that would have applied in the absence of a merger.

If one of the plans involved in the merger is operating based on a range certification, the following options are available:

- Provide a new range certification reflecting the combined AFTAP of the merged plan.
- Calculate the combined AFTAP, assuming that the AFTAP of the plan using the range certification is at the low end of the certified range. Note that this approach often will result in unreasonably understated AFTAPs and, as a result, could impose restrictions in cases for which they are not warranted. This, therefore, is not a preferred approach. But having any rule that can be applied definitively is preferable to a vacuum that prevents new benefit commencements from occurring at all.
- Rescind the range certification and revert to the presumption rules.

Special rules for retroactive change in status

Based on the above rules, a plan's status might change as a result of a merger. A plan with a prior year FTAP of more than 80 percent, for example, might see that FTAP drop below 80 percent, triggering at-risk status and restrictions on use of funding balances. A plan, similarly, could become subject to benefit restrictions (or a higher level of restrictions). In these situations, the following special rules would apply:

- The plan sponsor, if the prior year Schedule SB has not yet been filed, would be permitted to elect to waive a sufficient amount of prior year carryover or prefunding balances of either plan within 30 days of the merger to avoid a retroactive change in status—even though the normal deadline for waivers has passed. To maintain consistency with existing IRS regulations, this waiver could be structured as a waiver of current year balances, discounted back to the prior year valuation date based on the prior year return on assets. This rule would be similar to the special rule that applied to 2007 FTAP determinations.
- Elections to use carryover or prefunding balance prior to the merger would not be affected by a retroactive drop in prior year FTAP to below 80 percent.
- A reduction in FTAP as a result of a merger occurring after the valuation date that triggers at-risk status would not cause a redetermination of current year valuation results using at-risk rules. The other consequences of at-risk status would apply following the merger.

<u>Plan Spinoffs</u>

The fundamental problem for plan spinoffs is that the IRC Section 414(l) asset allocation rules may result in a substantial change in the funded level of the successor plans as of the date of the spinoff. It is generally impossible to measure precisely the effect of a spinoff on the AFTAP until well after the transaction date. If the effect of the spinoff must be reflected immediately as of the date of the transaction, this approach may leave the plan with no AFTAP, presumed or otherwise, for a period of time.

For a mid-year spinoff, the choice of approach may depend on whether or not the plan has a new valuation on the spinoff date or whether it continues to rely on the pre-spinoff valuation. We assume that, due to concerns over data and timing, most transactions involving larger plans will rely on the pre-spinoff valuation. According to Q&A No. 7 from the 2009 Gray Book, this approach is still valid after PPA. For minimum funding calculations, the final regulations should continue to allow this approach as well as the ability to conduct a new valuation for the affected plan.

To allow for ongoing plan administration, we recommend that some combination of the following options be considered for plan spinoffs:

- For some specified period of time following the date of a spinoff, each successor plan should be permitted to rely on funding ratios that would have applied to the ongoing plan had no spinoff occurred. The AFTAP post-spinoff for each plan, for example, would be equal to the pre-spinoff AFTAP (subject to the same rules with respect to adjustments to presumed AFTAP and timing of AFTAP certification). Anti-abuse language could be added for situations in which the ERISA 4044 priority of the two groups is significantly different and in which the post-spinoff AFTAP is likely to be both substantially below the pre-spinoff AFTAP and also below a key Section 436 threshold.
- For some longer period of time (e.g., the lesser of one year or the date the exact asset transfer has been calculated), calculations should be permitted to rely on an estimate of the final asset allocation. This approach simply could allow for an actuary's best estimate (perhaps subject to some corridor, e.g., 90 percent to 110 percent of the ultimate asset allocation). As an alternative, guidance could specify a simplified approach for estimating the asset allocation in accordance with ERISA 4044. For example:
  - Liabilities would be determined using interest and mortality assumptions that actually will apply to the asset allocation, but leave all other valuation assumptions unchanged.
  - Estimated Priority Category (PC) 3 liabilities would include all liabilities for any participant who met the plan's early retirement requirements three years prior to the spinoff date. For retirees and terminated vested participants who met the minimum age requirement and for whom service data are not available, the actuary should assume that the service requirement also was met.
  - Estimated PC4 and PC5 liabilities would be incorporated into a single category consisting of all remaining vested benefits.

- Anti-abuse provisions could restrict the sponsor's ability to take advantage of these provisions for spinoffs involving key employees or in cases in which there has been a significant plan amendment improving benefits during the last five years or in cases in which there is a special schedule due to a prior merger that is likely to have a significant effect on the ultimate allocation of assets.

Valuation approaches for mid-year spinoffs

Guidance should provide for reasonable approaches for mid-year spinoffs. If liabilities are not revalued on the spinoff date, then valuation results should be allocated to successor plans on a reasonable basis for the short plan year. One possible approach is to directly calculate funding target and TNC for each successor group as of the valuation date, but allow for an estimated asset allocation to be used, as described above. TNC for the post-spinoff period would be calculated either as a pro rata allocation for the spunoff group or as a full-year TNC less TNC calculated for the pre-spinoff period, with either approach being acceptable. Shortfall amortization bases can be allocated in proportion to funding shortfall for each group. Shortfall amortization installments for the affected plan would be allocated in proportion to the shortfall amortization bases, and prorated to the pre- and post-spinoff periods. Assets as of the valuation date would be allocated in proportion to the estimated market value asset allocation as of the spinoff date. This is a deliberate change from the approach currently described in the final regulations, which generally yields unreasonable results.

Spinoffs may involve multiple plan sponsors, which can make any later adjustment to reflect the actual amount of assets spun off particularly problematic. We recommend that the estimated asset allocation continue to be used for valuation purposes—even after the revised amount is available.

Allocation of funding balance

We recommend continued flexibility in the allocation of a plan's funding balances. Rev. Rul. 81-212 suggests redetermining the asset allocation using assets less the credit balance (funding balances), but states that this is only one acceptable approach. This approach tends to allocate the funding balance in proportion to the marginal rate of asset allocation. It also produces the unfortunate result of requiring a 4044 allocation for well-funded plans with large funding balances— which otherwise would not require a 4044 allocation because benefit liabilities are fully funded—solely to allocate the funding balance. This is true even for very small spinoffs within a controlled group (e.g., the transfer of liabilities to the salaried plan for former hourly employees), which are not *de minimis* solely because surplus assets must be allocated to the group that has been spun off. We believe that it also would be reasonable (perhaps more reasonable) to allocate the funding balances directly in proportion to the allocation of assets. If only a single approach is permitted in final guidance, we would recommend this latter approach.

Lookback calculations

For purposes of prior year lookbacks (e.g., FTAP for determining quarterly contributions, at-risk status, and eligibility to use funding balances), we recommend that the actual prior year funded ratio for the pre-spinoff plan be used. This approach will avoid confusing mid-year changes in valuation rules for either component of the plan.

We understand that there may be some concern about using this approach for benefit restriction purposes (i.e., determining the prior year AFTAP used to determine current year presumed AFTAP). As discussed above, it would be helpful at least to be able to use this approach for a limited period of time (e.g., six months) to permit the completion of preliminary spinoff estimates. After that, prior year assets and funding balances could be allocated in proportion to the actual or estimated allocation of current year assets, while prior year liabilities could be allocated in proportion to current year liabilities. For cases in which actual results are different from the estimate by enough to result in an immediate change in plan administration, it may be appropriate to allow a one-month grace period before the actuary is required to issue an updated AFTAP to avoid abrupt changes in plan administration.

Actuarial asset value
To determine actuarial asset value after a spinoff, the smoothing history of the pre-spinoff plan must be allocated in some manner. Current regulations appear to state that the spinoff would be treated as equivalent to a benefit payment, assigning no history to the plan that was spun off. This approach can produce some odd results and is subject to manipulation—particularly if the portion of the plan being spun off is large in relation to the size of the pre-spinoff plan. A reasonable, but simple, alternative would be to allocate smoothing history in proportion to the assets being spun off. We recommend that the regulations incorporate this alternative approach.

Transfers

Transfers generally would be treated as a spinoff followed by a merger. Reasonable estimates consistent with the approaches described above should be permitted.

In most cases, the approaches described above for spinoffs define specific values for assets, liabilities, and funding balances that then can be used in applying the merger rules. In some cases, however, we have recommended that current or prior year ratios be used for some period of time following a spinoff. In these cases, the corresponding ratio for the post-merger plan would have to be calculated as a weighted average (based on funding target) of results from the pre-merger plans.

De minimis Mergers and Spinoffs

Mergers
The *de minimis* rule was established in the IRC Section 414(l) regulations to simplify calculations in which one of the plans involved is very small relative to the other and would have little effect on the assignment of benefits to priority categories for the larger plan.

Rev. Proc. 2000-40 established rules for funding calculations involving *de minimis* mergers in which the effect of the merger on the larger plan is disregarded until the first valuation date on or after the merger. The Rev. Proc. relies on the same *de minimis* standards as Section 414(l).

We recommend that the same basic approach be applied to PPA funding calculations and that the *de minimis* rule be extended to benefit restriction calculations under Section 436.

Specifically, we recommend the following:

- Funding calculations follow the same rules as described in Rev. Proc. 2000-40. The small plan would follow the short plan year rules if the merger occurs before the end of the plan year. The large plan would disregard the small plan for purposes of all funding calculations until the valuation date next following or coincident with the merger.
- *De minimis* mergers are disregarded for purposes of benefit restrictions until the valuation date coincident with or next following the merger. Until the AFTAP is certified based on that post-merger valuation date, the AFTAP or presumed AFTAP would be based solely on valuation results for the large plan as if the merger had not occurred. In this way, Section 436 treatment of the *de minimis* group would match that of the larger plan.

Retroactive loss of de minimis status
A merger is *de minimis* if the present value of accrued benefits (PVAB) for the plan being merged in is less than 3 percent of the assets of the larger plan on at least one day of the plan year of the larger plan in which the merger occurs. Subsequent mergers during the same plan year (or mergers over more than one plan year designed to occur in steps) that would otherwise satisfy the *de minimis* rule must be aggregated with any earlier *de minimis* mergers for purposes of the 3 percent test. As a result, a merger can retroactively change status from *de minimis* to non-*de minimis*.

The retroactive change in status has been an issue since well before PPA. In this case, the valuation must be adjusted to reflect the non-*de minimis* status of the merger. Post-PPA, we have the additional complication of funding balance elections and compliance with Section 436 that might have operated differently had the original merger been treated as non-*de minimis* from the start. To avoid retroactive late quarterly contributions and benefit-restriction compliance failures, we recommend that if the 3 percent test is failed due to a series of mergers, the merger be treated as occurring on the date of the subsequent merger, rather than on the original date of the (then *de minimis*) merger.

Spinoffs
The Section 414(l) regulations provide a similar *de minimis* rule for spinoffs. If the PVAB is less than 3 percent of plan assets, an amount equal to the full PVAB can be spun off instead of following the more complex asset allocation rules (except in certain spinoffs within the controlled group in which surplus must be allocated). In the case of spinoffs in which the sponsor elects *de minimis* treatment, we recommend that the effect of the spinoff on the ongoing plan be disregarded for all purposes, except for cases in which the spinoff occurs at the beginning or end of the plan year. We specifically recommend that:

- No COB or PFB would be allocated to the plan that is spun off;
- There would be no adjustment to the calculation of the MRC;
- The spinoff would have no effect on the AFTAP or on the operation of benefit restrictions for the larger plan until the next valuation date (as described in 2009 Gray Book Q&A No. 36).

Except in the case of a spinoff termination, a spinoff will result either in a new plan or a merger with another plan. In both situations, the group that is spun off should be treated as being fully funded, since the asset transfer is equal to the full PVAB on a reasonable basis, as was indicated in 2009 Gray Book Q&A No. 36.

If the spinoff results in a new stand-alone plan, the treatment would be as follows:

- No shortfall amortization base would be established;
- A partial year TNC would be calculated based on a proration of the TNC for the group spun off from the original (pre-spinoff) valuation;
- The plan that is spun off would be treated as having a certified AFTAP of 100 percent for the remainder of the plan year and a presumed AFTAP of 100 percent the following year (assuming no other events that give rise to a remeasurement of the AFTAP).

If the spinoff results in a merger with another plan, the proposed treatment, assuming that the merger is not *de minimis* with respect to the other plan and that the merger occurs after the valuation date for the other plan, is as follows:

- No shortfall amortization base would be established as a result of the merger;
- A partial year TNC would be calculated based on the original (pre-spinoff) valuation (i.e., the same TNC that would have been used if the spinoff resulted in a stand-alone plan);
- Assets transferred would be discounted back to the valuation date for the plan into which the plan that is spun off is merged using that plan's EIR (calculated without regard to the merger) for purposes of calculating AFTAP and FTAP of the merged plan for the post merger period;
- Funding target for the group that is spun off would be treated as being equal to the assets transferred, discounted to the valuation date as described above.

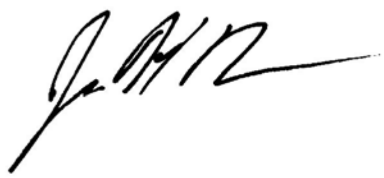
More Than One Actuary

In some of the transactions discussed above, there may be more than one actuary involved. An actuary generally would not issue a certification based on the work of an actuary from another firm. If another actuary has already issued a specific AFTAP certification, however, this specific certification should be allowed to be treated as a data element in the successor actuary's calculations, where appropriate. In the case of a mid-year merger, for example, the actuary for the disappearing plan generally will issue a certification for that plan. Once that certification has been issued, another actuary should be permitted to use this information in the calculation of the post-merger AFTAP.

For funding purposes, some of the valuation results for the disappearing plan in a merger may affect the minimum funding calculations. As long as the other actuary is preparing the Schedule SB for the final (possibly short) plan year for the disappearing plan, the actuary for the ongoing plan should be permitted to rely on those results to the extent necessary to follow the rules described above without having to do a separate calculation.

We would be happy to discuss any of these items 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,



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