Intersector Group Report to the American Academy of Actuaries[1] Pension Practice Council

Meeting with the U.S. Department of Treasury/Internal Revenue Service – October 15, 2014

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Notes from Intersector Meeting with IRS/Treasury
October 15, 2014

The Intersector Group is composed of two delegates from each of the following actuarial organizations: American Academy of Actuaries, Society of Actuaries, Conference of Consulting Actuaries, and ASPPA College of Pension Actuaries. Twice a year the Intersector Group meets with representatives of the U.S. Department of Treasury (Treasury Department) and the Internal Revenue Service (IRS) to dialogue with them on regulatory and other issues affecting pension practice. Attending from the Intersector Group were: Tom Finnegan, Eli Greenblum, Eric Keener, Judy Miller, Heidi Rackley, Maria Sarli, and Larry Sher. Matthew Mulling, Academy staff member supporting the Intersector Group, also attended.

These meeting notes are not official statements of the Treasury Department or the IRS and have not been reviewed by its representatives who attended the meetings. The notes merely reflect the Intersector Group's understanding of Treasury Department/IRS representatives' views expressed at the meeting, and are not to be construed in any way as establishing official positions of the Treasury Department, the IRS, or any other government agency. The notes cannot be relied upon by any person for any purpose. Moreover, the Treasury Department and the IRS have not in any way approved these notes or reviewed them to determine whether the statements herein are accurate or complete.

Discussion items:

1. **Update from IRS/Treasury -** Guidance projects of particular interest to pension actuaries include the following:

   - The funding group is working on final Code Section 430 funding regulations, proposed Section 404 deduction rules, automatic approval for changes in funding method (successor to Revenue Procedure 2000-40), process for requesting approval of a change in funding method (successor to Revenue Procedure 2000-41), and guidance for cooperative and small employer charity plans and eligible charity plans.
   - The cash balance/hybrid plan group is working on pension equity plans (PEPs) and projection issues (including applying 415 limits to hybrid plans).
   - IRS/Treasury are also working on some other projects that would affect defined benefit or defined contribution plans, including guidance on disclosures about the consequences of failure to defer benefits.

   There is a trade-off between providing guidance that is less comprehensive sooner versus more comprehensive later. For example, IRS/Treasury made a tactical decision not to cover hybrid plan projections in the recently released final regulations because it would have slowed down publication of the guidance on market-rates of return.

   A discussion of the trade-offs around automatic approvals of changes in funding methods followed. The Intersector Group urged IRS to quickly provide "rifle-shot" guidance providing automatic approval for a change in enrolled actuary and actuarial firm when the new actuary has replicated the prior actuary's *current*-year results as shown in the prior actuary's certified valuation report (using segment rates under either the Moving Ahead for

Progress in the 21st Century Act (MAP-21) or the Highway and Transportation Funding Act (HATFA) in the case of 2013 and 2014 transitions; see discussion item 3 below), even if this could delay issuance of broader guidance including automatic approvals for changes in asset methods and changes in connection with plan mergers and spin-offs. However, IRS/Treasury noted that they have an incentive to get the broader guidance done, due to their lack of resources to review funding method change applications.

2. **HATFA and IRS Notice 2014-53 –** We appreciate the timely guidance in Notice 2014-53, but there are a few areas where additional guidance (perhaps a newsletter article) would be beneficial.

   a. Notice 2014-53 did not spell out the deadlines for electing retroactive application of HATFA adjusted funding target attainment percentage (AFTAP) to the date of the first 2013 MAP-21 AFTAP certification or the date of the first 2014 AFTAP certification or for reversing 2014 reductions in funding balance. Plan sponsors and actuaries need definitive guidance to make sure these deadlines are not missed.

      Discussion Summary:

      The IRS/Treasury representatives indicated the election should be made by the later of the filing deadline for the plan year and December 31, 2014.

   b. Actuaries also need definitive guidance on how Form 5500 Schedule SB should be completed for sponsors whose elections to apply carryover or prefunding balance toward 2013 contribution requirements exceeded the MRC using HATFA rates, and that elect to reverse the resulting waive at the start of the 2014 plan year.

      Discussion Summary:

      The IRS/Treasury representatives indicated that as long as actuaries explain what they did in an attachment, they aren't concerned about exactly how the Schedule SB is completed. To some extent, the approach the actuary uses may be dictated by the capabilities of third-party Form 5500 software. The Intersector Group agreed third-party software was a consideration, but felt the software vendors would modify their systems to accommodate an IRS prescribed approach.

3. **Automatic approval for change in actuary –** Announcement 2010-3 provides automatic approval for a change in actuary and actuarial firm when the new method is substantially the same as the prior method as reported in Schedule SB or described in the valuation report and the new actuary replicates the prior actuary's funding target, target normal cost, and actuarial value of assets for the prior plan year within 5%. As a practical matter (at least for large plans using beginning of year valuation dates) the actuary is almost always replicating results from a valuation report because the current year's AFTAP certification is often provided before the prior year's Schedule SB is filed. Given the requirements to send various elections made throughout the year to the enrolled actuary, providing automatic approval when the new actuary replicates the current year's results as shown in the prior actuary's valuation report

would greatly simplify transitions for both plan sponsors and actuarial firms. The need to replicate prior-year results is particularly problematic for 2014 changes in actuary, given the HATFA discount rate changes retroactive to 2013. In many cases, the new actuary will have replicated 2013 results from the prior actuary's valuation report based on MAP-21 rates, prepared a 2014 AFTAP certification and valuation, and be acting as enrolled actuary for the plan. But if the sponsor now wants to use HATFA rates for 2013, it would appear they must either:

a. Go back to the old actuary to revise the 2013 valuation – in this case, it isn't clear whether the new actuary needs to match the revised 2013 valuation using HATFA rates, or whether matching the MAP-21 valuation report is sufficient to support automatic approval.
b. Have the new actuary revise the 2013 valuation results and request IRS approval of the method change in connection with the change in actuary.
c. Have the new actuary revise the 2013 valuation results and replicate the prior actuary's 2012 valuation results to support automatic approval.

Expanding automatic approval to allow replication of current year results shown in the prior actuary's valuation report (using either MAP-21 or HATFA rates in the case of 2013 and 2014 transitions) would solve this problem. It would also be helpful with transitions long term. Once the new actuary has replicated the prior actuary's current year results, the new actuary can assume responsibility for all the functions of the plan's enrolled actuary from that date forward (including signing Schedule SB), and plan sponsors will need to send various elections to only one actuary.

The group did not discuss this question because it was covered as part of the IRS update (see item 1).

4. **Longevity annuities in defined benefit plans –** The final qualified longevity annuity contract (QLAC) regulations issued in July allow defined contribution plans to provide deeply deferred annuities without concern about compliance with the minimum distribution rules, provided that certain conditions are satisfied. The availability of a deeply deferred annuity could be an attractive option in a defined benefit plan where benefits could be provided without having to secure insured annuity contracts. Does Treasury have plans to expand the QLAC guidance to DB plans? If not, what are the concerns with doing so?

Discussion Summary:

The Intersector Group pointed out that the ability to offer a partial lump sum in combination with a deeply deferred annuity in a defined benefit plan could be an attractive option for participants in lieu of a total lump sum, and would avoid fiduciary concerns around the selection of an annuity provider, gender-specific market pricing, and insurer expense and risk loads in pricing that are currently inhibiting the use of QLACs in defined contribution plans.

The IRS/Treasury representatives indicated they are interested in comments on the DC plan QLAC rules, but are open to also allowing longevity annuity options in defined benefit plans.

Any future guidance will come out in proposed form. The agency did not address defined benefit plans in the July regulations because they already offer annuities, and due to a concern about how to avoid "excessive" deferrals. For example, they would be concerned about an optional form that, in lieu of a $1,000/month level lifetime income, provides $700/month until age 85 then jumps to $5,000/month. IRS/Treasury needs to get comfortable with what a "model" might look like for a DB plan, and not allow endless permutations. The Academy has promised to provide suggestions in that regard. The Intersector Group indicated that we would also want any rules to permit a rollover from a DC to a DB to purchase a QLAC. IRS/Treasury indicated that for people who had no DB benefit to begin with, there was a statutory problem with permitting a DC to DB rollover and not starting the benefit by 70-1/2.

5. **Update on closed plan nondiscrimination –** Can you give us an update on your progress on re-examining this issue? Has the introduction of legislation (the Portman/Cardin bill (S. 2855) in the Senate and the Neal/Tiberi bill (H.R. 5381) in the House) that would remedy the primary issues (by allowing plans that passed 401(b)/401(a)(4) and 401(a)(26) when they were closed to new entrants, and were not significantly changed, to continue to pass 401(a)(26) and BRF testing and to be able to aggregate and cross-test with DC plan benefits (including 401(k) matches and ESOPs) for 410(b)/401(a)(4) without regard to cross-testing gateways) affected your work on this project in any way?

   Discussion Summary:

   The IRS/Treasury representative reported they are making good progress on permanent relief. They haven't stopped work on this because of the bills that have been introduced. They have no current view on whether they will extend Notice 2014-5 if guidance is not provided before the end of 2015.

6. **Multiple Employer Plan Funding –** Multiple employer plans established after 12/31/1988 (or plans converted after that date) are subject to Code Section 413(c)(4)(A), which requires that "each employer shall be treated as maintaining a separate plan for purposes of section 412 unless such plan uses a method for determining required contributions which provides that any employer contributes not less than the amount which would be required if such employer maintained a separate plan." 413(c)(7)(B) provides that "for purposes of applying paragraphs (4)(A) and (6)(A) the assets and liabilities of each plan shall be treated as the assets and liabilities which would be allocated to a plan maintained by the employer if the employer withdrew from the multiple employer plan." There is little statutory guidance on how assets and liabilities are allocated on withdrawal. However, there does not seem to be an impediment to a plan adopting reasonable withdrawal liability allocation rules. Suppose that a multiple employer plan adopts a "direct attribution" approach for purposes of determining withdrawal liability. Under this approach, assets are tracked separately for each employer based on that employer's contributions, benefit payments made to employees and former employees of that employer, a reasonable allocation of plan expenses, and plan earnings on the allocated assets. Liabilities are those attributable to the employees and former employees

of that employer. 413(c)(7)(B) would seem to require that the same asset allocation be used for purpose of funding calculations. Is this a correct interpretation?

Discussion Summary:

The IRS/Treasury representatives haven't worked on this issue and can't say whether this interpretation would be reasonable. They suggested including this topic in the 2015 Gray Book.

The Intersector Group indicated there are three multiple employer plan areas where more workable approaches are needed: (1) asset allocation methods as described above, (2) a more liberal approach than the "common nexus" rules that prohibit unrelated employers from participation, and (3) the "one bad apple" problem where noncompliance by one participating employer currently taints the entire plan. IRS indicated some concerns with respect to "open MEPs" (i.e., with no common nexus) given prior experience with other types of benefit plans.

7. **Possible partial sunset of IRC 432 multiemployer zone rules –** In the absence of legislation that might be enacted during the upcoming lame-duck session of Congress, there would be a partial "sunset" of the IRC 432 multiemployer "zone" rules in 2015. What guidance is the Service considering, to help plan sponsors (and their actuaries) cope with the uncertainty that lies ahead? For example, should endangered and critical status plans continue to file status certifications by the 90th day of the 2015 plan year?

   Discussion Summary:

   The IRS/Treasury representatives indicated they are "making contingency plans," but would not prepare guidance until it becomes clear that there will be no Congressional action this year. Due to resource constraints they can't divert resources from other projects to work on something that legislation may fix. They can't say how long it will take to issue guidance once it is clear the sunset will occur.

8. **Notice of funding waiver request –** A notice to participants is required when the sponsor files for a funding waiver. Can this notice be provided electronically?

   Discussion Summary:

   The IRS/Treasury representatives indicated electronic delivery rules (that is, the 1.401(a)-21 regulations) apply, but practitioners must be aware of the differences between the IRS and Department of Labor (DOL) electronic notice rules. Many DOL notices are "mass mailings" while few IRS notices are. DOL has a very strict electronic deliver regime, balanced with "deemed deliver." IRS has an easier electronic delivery process, but the notice must be actually delivered. The two sets of rules are difficult to reconcile, and attempts to do so legislatively have failed due to push-back from interest groups. So you must follow IRS rules but confirm it was delivered. Not clear what that means – do you need a return receipt on an e-mail indicating it was opened?

9. **Hybrid plan final and proposed regulations.** *[There was not sufficient time to discuss all of the following issues. These notes provide the IRS/Treasury reaction on those issues that were discussed.]*

   a. With respect to cash balance plans crediting interest equal to the actual rate of return on plan assets or a subset of plan assets:

      - Would it be acceptable to base interest credits on a specified portion of the plan's assets – for example, all the plan assets except hedge funds and employer stock?
      - If the plan provides both cash balance and traditional DB benefits and is (or becomes) less than 100% funded, must interest credits be based on the return on all of the plan's assets rather than on a specified "cash balance" subset? Or, could the plan shift assets from the non-cash balance subset to the cash balance subset, assuming there are sufficient assets to cover the entire asset shortfall in the cash balance subset?

      Discussion Summary:

      The IRS/Treasury representatives explained that the market value of the identified subset must be "approximately equal" to the benefit liabilities credited with the return on the subset, but there is no need for the plan as a whole to be fully funded. Thus, if the subset of assets (not including the excluded assets) are insufficient to satisfy the approximately equal requirement, assets not otherwise assigned to the subset (or other subsets) would have to be added to the subset to the extent needed. If all such unassigned assets are still inadequate, some or all of the excluded assets would have to be added to the subset. If the total plan assets are less than the benefit liabilities associated with the subset, the interest crediting rate would be based on the return on all of the plan's assets. The examples in the final regulations make clear that a seven-year amortization of any gains or losses is sufficient to keep the subset value and benefit liabilities "approximately equal."

      The IRS/Treasury representatives also stressed that the plan document must describe how the subset is identified (for example, a specified subaccount maintained within the trust), though the document need not specify how the subset is invested. The description will need to be flexible enough to withstand investment changes while also being descriptive enough to be definitely determinable and to withstand participant challenges. The plan document should also specify how the actual return on the subset is calculated to determine the crediting rate (for example, how are cash flows during the year treated in determining the rate of return).

   b. The preamble to the final regulations indicated that the cash balance plans would be able to credit interest based on a rate of return that differs for different groups of participants "such as using a more conservative, or less volatile, subset of plan assets for longer service employees." Would varying the basis using target-date principles (which are akin to a qualified default investment in a DC plan) be another acceptable approach? Can this same approach be used if interest credits are not based on actual asset returns? For

example, could a plan credit interest at the 30-year Treasury rate for the first 20 years and the greater of the 30-year Treasury rate or 5% after 20 years?

Discussion Summary:

The IRS/Treasury representatives explained that any sort of age-based criteria would take you out of the age discrimination safe harbor for lump sum-based plan formulas, which means that the plan would have to satisfy the general age discrimination requirements of IRC section 411(b)(1)(H)(i). They commented that they were careful that the example they provided in the preamble depended on service, not age. It was noted that while a service based criteria would meet the age discrimination safe harbor, it should be structured so as to not run afoul of IRC 411(b)(1)(G). However, it would also be possible to satisfy the safe harbor by varying the crediting rate in a given period in some other way, such as based on years since the participant entered the plan.

c. The final regulations did not include in the exclusive list of allowable interest crediting bases for cash balance plans the ability to use commonly recognized indices – even those mentioned as benchmarks in the final regulations for determining whether a registered investment company (RIC) is sufficiently diversified, i.e., the S&P 500 and Russell 2000 indices. (The inability to use such indices was confirmed in the examples in the 2014 proposed regulations.) Is this omission likely to be rectified by the issuance of separate guidance allowing the use of particular indices in the near future? If not, what is the rationale for allowing such an approach for a variable annuity plan but not for a cash balance plan?

Discussion Summary:

The IRS/Treasury representatives indicated the final regulations do not allow this because (1) there is no clear line on which indices would be acceptable (for example, the Dow Jones Industrial Average might not be sufficiently diversified for use as a crediting basis) and (2) the representatives believe there is not a single number that represents the rate of return on an index – the return can be difficult to calculate, especially when companies in the index are involved in transactions. At this time, the agency has no intention of expanding the list of permissible rates to include indices.

The Intersector Group expressed its understanding that there is a single number that represents the rate of return on commonly recognized indices such as the S&P 500 price index. The disparity observed by the IRS/Treasury representatives is among the various RICs that mirror the returns on a particular index, not on the index itself.

d. The final regulations continue to take the view that in a cash balance plan that provides investment-based interest credits that "projections" for purposes of accrual rule testing should be performed by assuming that the "interest crediting rate used to compute benefits as of the current year" remains unchanged in all subsequent years until normal retirement age, unless the rate of return in the "prior year" is negative, in which case 0% can be used in the projection. Earlier in the preamble, a reference is made to language in

Section 1.411(b)-1(b)(2)(ii)(D) which states that for purposes of the 133-1/3 percent rule, "all relevant factors to compute benefits... are treated as remaining constant as of the beginning of the current plan year for all subsequent plan years."

- The preamble does not discuss how the "interest rate used to compute benefits as of the current year" rate should be determined in a plan that credits investment-based returns given that, unlike the rate in a bond-based plan, there is no comparable "look-back period" where the rate is locked in for a given "stability period." Rather, the rate of return for a given period is not known until the period has ended. Thus, it is not clear whether the projection should be based on (1) the rate of return on the day of the distribution or on the first day of the plan year of distribution – compounded for 365 days; (2) the annualized rate of return for the preceding interest accrual period (e.g., day, month, quarter, plan year, etc.); (3) the rate of return for the current plan year to date (annualized); or (4) the rate of return for the prior plan year.
- It is also unclear as to whether this kind of projection should be made for all purposes for which a projection is required under the Code – notably 415 and 401(a)(4). The preamble also does not discuss whether such a projection overrides explicit plan provisions to the contrary, such as a definition of accrued benefit that defines how the account balance is converted to an accrued benefit (expressed as a normal retirement annuity) as of any determination date.

Discussion Summary:

IRS is scoping out a project on projection issues that may address some or all of these questions.

e. The final regulations provide that if a plan changes its interest crediting basis from one permissible method to another permissible method, that providing Code Section 411(d)(6) protection by continuing the old basis on the account balance (without future pay credits) as a minimum is generally acceptable for active employees. However, the regulations indicate that such treatment is not acceptable for terminated employees because their entire account balances would be receiving interest that is above a market rate (the greater of two acceptable bases). How should this restriction be applied to a plan that amended its interest crediting basis after 2006 but before the issuance of final regulations from an acceptable bond-based method to an acceptable market-based method? Must the interest crediting basis revert to the prior bond-basis prospectively (beginning no later than 2016) and the 411(d)(6) benefit be eliminated? Must the plan continue to credit the greater of the old and new rates, but cap interest credits at the third segment rate? Or would it be acceptable to continue the "greater of" treatment on the theory that it was a reasonable interpretation of the statute?

Discussion Summary:

The IRS/Treasury representatives indicated the proposed regulations did not cover this and recommended writing a comment letter.

f. The final regulations permit a plan to substitute a new RIC in a situation where the existing RIC specified in the plan is no longer in existence. The regulations, however, are silent as to whether it is acceptable or required to replace an existing RIC if its investment strategy is materially changed (perhaps where it would no longer satisfy the diversification requirement) or if a plan fiduciary determines that the RIC's investment performance has been substandard. What is the Treasury/IRS position on how to handle these situations?

Discussion Summary:

The IRS/Treasury representatives indicated the final regulations do not provide any 411(d)(6) relief in these situations. IRS/Treasury representatives expressed skepticism that the SEC would allow a RIC to materially change its investment strategy. The plan can change the crediting rate for active participants (but not terminated vested participants) but must protect benefits accrued before the effective date.

g. The preamble to the final regulations indicate that the ability of a lump-sum-based plan to pay lump sums equal to the current account balance (in satisfaction of Code Section 417(e)) does not apply to other defined benefit plans, including similar effect plans. May a variable annuity plan determine a lump sum by taking the present value of the accrued normal retirement annuity (with prior indexing but no future indexing) using the plan's specified "assumed" rate? If not, does the IRS have a position on how these lump sums should be determined in a VAP?

This issue was not discussed.

h. The final rules explicitly permit a reduction in PEP balances on account of a decrease in final average compensation or an increase in the integration level under an integrated formula. This appears to be a change from the position often expressed with respect to traditional formulas that a decrease in the accrued benefit due to a decrease in final average pay or an increase in an integration level would be on account of service, and therefore prohibited. Has the IRS thinking changed in this area?

Discussion Summary:

The IRS/Treasury representatives indicated Example 4 in longstanding Treasury Regulations Section 1.411(a)-7(c)(6) shows pay going down under a traditional formula and indicates that the normal retirement benefit cannot be less than any previous early retirement benefit (taking into account the reductions for early commencement of benefits) but does not note that the resulting reduction in the accrued benefit would be a problem under Code Section 411(b)(1)(G) (which bars reductions in accrued benefits on account of increasing age or service, and has been interpreted to mean that the accrued benefit cannot be lower if a participant continues to work than it would have been if the participant had terminated). Given this example, this would be a "huge trap for the unwary" if IRS took the position traditional formula benefits cannot be reduced because

of a decline in final average pay. [Note that 2008 Gray Book Q&A 42 and 2003 Gray Book Q&A 33 took a different view.]

i. The modified definition of "lump-sum-based formula" appears to exclude those cash balance plans that continue to do lump sum whipsaw calculations. This could mean that such plans are not eligible for the safe harbor age discrimination protection, or perhaps that these plans are to be considered "indexed plans," which get different age discrimination protections. Please explain how a cash balance plan that continues to do whipsaw calculations is treated under the final regulations and whether such plans are now forced to eliminate whipsaw prospectively.

Discussion Summary:

The IRS/Treasury representatives indicated cash balance plans that continue to do lump sum whipsaw calculations do not meet the definition of a "lump sum-based formula" and cannot use the age discrimination safe harbor for lump sum-based formulas. They did not rule out the possibility that such plans might be able to fit within the special age discrimination rule for indexed benefits. Indexed plans are subject to Code Section 417(e) and must comply with Section 411(a) rules in the same way as plans with traditional formulas (that is, they must demonstrate that every possible optional payment form and time is no less valuable than the accrued benefit payable at normal retirement age using a reasonable actuarial basis). A cash balance plan that has a whipsaw provision can remove it by plan amendment, but would have to comply with IRC section 411(d)(6) – i.e., the lump sum could not be less than the pre-amendment account balance with interest and with whipsaw applied. Subsequent to such an amendment, the plan would be considered a lump sum based plan, since the definition of 'lump sum based formula" allows the payment of more than the accumulated benefit under such a formula to the extent required by 411(d)(6).

j. If a plan crediting an above market rate is terminated within five years after reducing the rate to comply with the final regulations effective for the 2016 plan year, are the pre-2016 above-market rates fully reflected in the five-year average rate credited post termination? For example, if a plan that was crediting a fixed 7% is amended to credit 6% for 2016 and later plan years, then terminates at the end of the 2018 plan year, is the five-year average rate 6.4%? Or is it limited to 6%?

Discussion Summary:

The IRS/Treasury representatives indicated that if the actual rate was "above-market" under the regulations that take effect in 2016, but was not above market under a reasonable interpretation of PPA, the actual rate should be used in the average, producing a rate of 6.4% in this example.

k. The proposed regulations providing anti-cutback relief don't state that plan sponsors can rely on them. Should employers be waiting for final regulations before amending their plans?

Discussion Summary:

The IRS/Treasury representatives indicated plan sponsors could not rely on the proposed regulations (and that generally reliance on proposed regulations is not provided for ERISA Title I issues) and therefore should wait for final regulations before adopting plan amendments, though they should begin planning now.