



AMERICAN ACADEMY *of* ACTUARIES

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Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 4024
Washington, DC 20220

David M. Ziegler
Manager
Employee Plans Actuarial Group
Internal Revenue Service
200 Constitution Avenue
Room N5655
Washington, DC 20210

Re: Increasing flexibility for elections to reduce funding balances

Dear Mr. Weller and Mr. Ziegler:

The American Academy of Actuaries¹ Pension Committee respectfully requests your consideration of its comments and recommendations for increased flexibility when electing to reduce funding balances.

For the reasons detailed below, a plan sponsor often concludes after the year-end deadline that it would have been preferable to have elected to reduce funding balances as of the end of the prior plan year. By missing the year-end deadline to voluntarily reduce funding balances, a plan sponsor may become subject to ERISA Section 4010 reporting, at-risk requirements, quarterly contributions, or benefit restrictions under the presumption rules three months into the following year—even though the plan in fact is sufficiently well funded to avoid these consequences.

For the following reasons, we believe that the year-end deadline is unreasonable, imposes an unnecessary burden on plan sponsors, and has no benefit:

- Funding balances can affect the multitude of funding ratios in different ways, with various impacts felt at different times. Because of this complexity, the consequences of a failure to reduce balances generally are not felt and therefore may not be recognized until about three months after the deadline (around the time of the 4010 filing, annual funding notice, first quarterly contribution, and the 10 percent drop in presumed Adjusted Funding Target Attainment Percentage [AFTAP]).

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

- The deadline falls well before final decisions on methods and assumptions otherwise would have to be locked in for a valuation (arguably when the final contribution is due for that plan year).
- There is no compelling reason for that deadline to be before other funding balance-related deadlines for the plan year.
- For a typical calendar year plan, the deadline falls at a time of year when it is difficult to get the right person at the plan sponsor to take any necessary action.
- The deadline falls before the actuary has enough information to know whether a forfeiture of balances to raise the AFTAP to 90 percent (to avoid having the presumed AFTAP drop below 80 percent three months into the following year) is warranted or whether a range or specific AFTAP certification might be a viable alternative.
- The deadline restricts the ability to correct problems discovered while working on the following year's valuation without causing Funding Target Attainment Percentage (FTAP)/AFTAP problems.

We therefore recommend that the deadline for reducing funding balances be extended and/or that standing elections to reduce funding balances be permitted.

Extending the deadline for elections to reduce funding balances

The ideal solution to this problem would be to extend the deadline for making elections to reduce funding balances so that it is the same deadline as for applying or creating them (that is, the deadline for making contributions for the prior plan year). We realize that this recommendation would require reversing an established regulatory position and may raise concerns about interactions with other funding balance-related elections for later plan years. As discussed below, we believe that these interactions are resolved easily and the resulting complications are less troublesome than those that already exist (e.g., deemed reductions in funding balances retroactively invalidating an election to apply balances to cover quarterlies or the Internal Revenue Code (IRC) Section 1.430(d)-1(d)(2) special rule retroactively increasing the minimum required contribution and thereby creating late quarterlies). We believe that the problem of interaction with later plan year deemed and voluntary elections could be addressed by allowing a prior year election to reduce balances only when doing so would not result in a material change in plan administration under IRC Section 436. The prior year election would take precedence over any current year election.

The early deadline is an especially acute problem for short plan years and end-of-year valuations, for which the information necessary to make an informed decision about whether to reduce a funding balance may not be available until well after the end of the plan year.

In most situations when a sponsor would want to make a "late" election to reduce balances, it is unlikely that this late election would create a conflict with the application of the Section 436 rules. Common situations include:

- Assets exceed funding target, so assets are not reduced in determining the AFTAP (which is in excess of 100 percent), but funding balances are large enough that the FTAP is less than 80 percent. Here a late election would have no effect on Section 436 calculations.

- A less well-funded plan does not provide accelerated payment forms, so there is no deemed reduction to get AFTAP to 80 percent and therefore the FTAP (which usually matches the AFTAP unless the plan is at-risk) is also below 80 percent. When there are no accelerated distribution restrictions, the 80 percent threshold is generally not important from a Section 436 perspective (except in the case of plan amendments), so again a late election would not have an effect on Section 436 calculations.
- The deemed reduction in balances increased the AFTAP to 80 percent, but due to slight difference between the two calculations (e.g., AFTAP is adjusted for NHCE annuity purchases but FTAP is not), the FTAP falls just short of 80 percent. A further reduction in balances to raise the FTAP to 80 percent would not affect plan administration.
- The AFTAP is between 70 percent and 80 percent and cannot be increased to 80 percent, but at-risk FTAP could be raised from below 70 percent to above 70 percent with a reduction in balances. Since the AFTAP would remain below 80 percent, there would be no Section 436 implications.

In these situations, the late election would not cause a material change in plan administration and so would be permitted. Late elections, of course, can affect current-year calculations. Examples include:

- Reduction of prior-year balances, when the resulting current-year balances already have been applied to satisfy current-year quarterly contribution requirements.
- Reduction of prior-year balances, when the resulting current year balances already have been reduced in the current year pursuant to a voluntary or deemed reduction in the current year.

Reduction of balances that had been applied to satisfy quarterly contribution requirements.

If funding balances already have been applied toward current-year quarterly contribution requirements, a subsequent election to reduce prior-year balances may result retroactively in late quarterly contributions. However, this situation already exists under current rules with timely elections to reduce balances or deemed reductions occurring at a Section 436 measurement date. Under the proposal, as under current rules, the plan sponsor would need to weigh the consequences of any such decision.

Reduction of prior-year balances that already have been reduced in the current year pursuant to a voluntary or deemed reduction in the current year.

This situation generally will not lead to problems if the reduction for the current year is adjusted automatically to leave no more than the same amount of funding balance remaining as was originally the case prior to the late election. For example, assume a 2012 deemed or elective reduction in balances of \$1,000,000, which is sufficient to produce a 2012 AFTAP of 80 percent. The sponsor subsequently elects to reduce the January 1, 2011, funding balances by \$500,000, which, after adjusting for interest, results in a \$525,000 reduction in funding balances for 2012. The original 2012 reduction would automatically adjust to \$475,000, which produces the same net result at January 1, 2012, as the original 2012 balance reduction.

One possible complication is the effect of a late election on the presumption rules. A late election would change the presumed funding target used to apply these rules. But since our proposed approach would allow a late election only when it would not create a material change in plan administration under Section 436, this would not be a problem.

Plan Amendments

If the sponsor of a non-collectively bargained plan adopted an amendment that did not take effect solely because the sponsor did not elect to reduce balances sufficiently to raise the post-amendment AFTAP to at least 80 percent, then permitting a late election could raise concerns. For instance, if the sponsor makes a late election that would raise the AFTAP above 80 percent by a sufficient margin to allow the amendment to take effect, should the amendment be permitted to take effect even though the end of the plan year has passed? The simplest approach would be to leave the treatment of these amendments unchanged. That is, the amendment is tested based on the AFTAP in effect no later than the end of the plan year. After that date, the amendment is treated as if it has been rescinded or, if the amendment has language that carries it forward to future plan years (an “evergreen” amendment), then it would be tested based on the AFTAP in effect in that future plan year. This approach avoids the potential problem of having to simultaneously test one amendment based on the AFTAP for two different plan years.

One potential concern with this approach is that it would allow a sponsor of a plan with an AFTAP of 80 percent to rescind an amendment simply by delaying a planned election to reduce funding balances beyond the end of the plan year. However, we do not think that this should be a major concern for the following reasons:

- Employers adopting plan amendments generally intend for these amendments to take effect.
- Employers already have the ability to prevent an amendment from taking effect by avoiding the necessary election to reduce balances (e.g., electing to reduce the funding balance just enough to reach a pre-amendment AFTAP of 80 percent but no further).
- The circumstances under which a sponsor would benefit from a late election for a plan with an AFTAP that is already at 80 percent are quite narrow. There is little reason for an employer to prevent the AFTAP from going sufficiently above 80 percent to permit an amendment to take effect and then to make a late election that would increase the AFTAP to this level. The main reason for a late election is to increase the FTAP to 80 percent (or some other important threshold). Rarely would the same election coincide with the increase in AFTAP that would have been necessary to permit an amendment to take effect.

If there is concern about potential abuse by employers looking for an indirect way to prevent amendments that they had adopted from taking effect, one option would be to prohibit late elections that would have this result (i.e., treat this situation as being akin to a material change in AFTAP). We believe that such a prohibition is unnecessary for the reasons mentioned above.

This is not an issue for collectively bargained amendments, as a deemed reduction would have occurred to permit the amendment to take effect.

A related situation is one in which a late election to reduce prior-year balances increases the presumed or certified AFTAP for the following year, affecting whether an amendment can take effect in that following year. For example, consider a plan with a certified AFTAP of 80 percent for 2011. The 2011 AFTAP would have been higher if the sponsor had elected to reduce more of the January 1, 2011, balances. The plan is amended in February 2012 to improve benefits. The amendment does not take effect on the scheduled effective date because the sponsor did not make a Section 436 contribution and did not elect to reduce the January 1, 2012, funding balances. On March 1, the sponsor elects to further reduce the January 1, 2011, funding balances, increasing the 2011 AFTAP to 82 percent. This increase provides enough of a margin to allow the 2012 amendment to take effect. Since the amendment would take effect as a result of a plan sponsor election to reduce balances, it would not be regarded as a material change.

Standing elections to reduce funding balances

An alternative to reversing a regulatory position would be to permit automatic (“standing”) elections to apply or reduce funding balances under certain circumstances. Note that our preferred approach of extending the election deadline likely would make this option unnecessary. We realize that those drafting regulations face many competing demands. While we believe it would be preferable to have greater flexibility in standing elections, we would assign this approach a lower priority than extending the election deadline.

Below we suggest a framework for permitting a standing election to reduce funding balances. Note that while we believe it is also important to permit a standing election to apply funding balances to cover quarterly contribution requirements, our hope is that regulatory guidance containing that option is already in development. We therefore have not addressed that issue in this letter.

A plan sponsor in many situations may prefer to reduce funding balances whenever possible to achieve a certain FTAP. Common circumstances include keeping the FTAP at no less than 80 percent to avoid at-risk status or to avoid triggering an ERISA Section 4010 filing with the Pension Benefit Guaranty Corporation (PBGC), keeping the FTAP based on at-risk liabilities at no less than 70 percent to avoid at-risk status,² or keeping the FTAP at 100 percent or more to avoid triggering the quarterly contribution requirement. A sponsor also might want to reduce balances as necessary to achieve an AFTAP of 70 percent or 90 percent to avoid the 10 percent drop in presumed AFTAP that otherwise would occur on the first day of the fourth month of the next plan year.

From a regulatory point of view, the simplest approach—and one that allows the sponsor the greatest flexibility—would be to permit standing elections to be written in formulaic terms, without restriction, as long as the amount may be definitely determined as of the date the reduction is deemed to occur.

Another option is to allow a standing election to reduce balances only under specific circumstances. We believe that this approach would reduce the likelihood of unintended

² Note that in this situation, a standing election would not work since there would be no certified value of the at-risk funding target by the end of the plan year.

consequences arising from a poorly conceived standing election without creating any regulatory or administrative complications. This option is described in greater detail below.

Under what circumstances would a standing election be permitted?

A sponsor should be permitted to make standing elections to reduce balances under any of the following circumstances:

1. To increase the FTAP to 100 percent to avoid triggering the quarterly contribution requirement;
2. To increase the FTAP to 80 percent to avoid at-risk status, a PBGC Section 4010 filing, and/or restrictions on use of funding balances;
3. To increase the AFTAP to 70 percent or 90 percent to avoid the automatic 10 percent drop in presumed AFTAP on the first day of the fourth month of the following plan year.

When does the reduction in balances occur?

The reduction in balances pursuant to a standing election must have an automatic timing mechanism. Under the current framework, this mechanism could kick in no later than the end of the plan year—the current deadline for reducing balances in the absence of the change recommended above. There is no advantage to having an automatic reduction apply before the end of the plan year. Having the reduction take place at a later date would afford greater planning opportunities, but, under very limited circumstances, could result in a material change in AFTAP or presumed AFTAP for the following plan year and so would have to be restricted in those situations. As a result, year-end is probably the most logical date for a standing election to take effect

As with a deemed election to reduce balances that occurs at a Section 436 measurement date, a standing election to reduce balances could retroactively eliminate balances that had been applied to one of the first three quarterly payments. This risk already exists for many plans and will have to be managed carefully for any sponsor using this standing election.

A standing election to reduce balances can apply only after the relevant valuation results have been certified. The calculation of the reduction generally uses the same valuation results reflected in the AFTAP certification, which is due by the end of the plan year. For a plan that has no AFTAP certification by end of the plan year (or for which the reduction is based on an amount different than the AFTAP), the standing election would not apply.

Differences between the AFTAP and the FTAP

In some situations, liabilities reflected in the AFTAP certification may differ from those used to determine the FTAP. For example, there may be a plan amendment that is reflected for Section 430 purposes, but is effective after the AFTAP has been issued. If the amendment does not result in a material change in the AFTAP, there is no requirement to recertify. Nevertheless, the liability that will be disclosed on the Schedule SB and which determines the FTAP will reflect this amendment. In a similar manner, there may be a plan amendment adopted during the plan

year that is not reflected for Section 430 purposes but nevertheless is reflected in the AFTAP certification.

Since the AFTAP certification is the only official certification of valuation results prior to the Schedule SB, the assets and liabilities disclosed on this certification are the only ones that can be applied in calculating the effect of a standing election to reduce balances. If there are potential differences between these amounts and the amounts that will be reflected on the Schedule SB, the sponsor and the actuary should be careful to ensure that either the standing election is cancelled and an affirmative election to reduce balances is made or that the AFTAP certification is updated to coincide with the Schedule SB before the standing election takes effect.

Short plan years and end-of-year valuations

Short plan years and end-of-year valuations create additional problems because the final day of the plan year, which is the deadline for reducing balances, may occur before the valuation results are available to the plan sponsor. One simple solution is to disallow any standing election to reduce balances for a short plan year or end-of-year valuation. It is instructive, however, to consider different situations.

Plan years that are at least nine months long and end-of-year valuations require a specific AFTAP certification before year-end to avoid the conclusive presumption that the AFTAP is less than 60 percent. Accordingly, a standing election to reduce balances could be applied on the same terms described above.

Plan years of less than nine months

Shorter plan years technically do not require a specific AFTAP certification. The presumption rules carry forward into the following plan year without triggering the conclusive presumption that the AFTAP is less than 60 percent. Based on the proposed approach for standing elections to reduce balances, no such election would be triggered in the absence of a specific AFTAP certification. Therefore, for these short plan years the standing election to reduce balances would apply only if a specific AFTAP certification is made before the end of the short plan year.

For plan years of less than nine months, if the deadline for electing to reduce balances remains the end of the plan year, then we urge the IRS to adopt a policy of leniency in considering requests to extend this deadline pursuant to Treasury Regulation Section 301.9100-3. Extending the deadline, of course, would reduce the number of requests that the IRS has to consider.

Conclusion

We believe the current plan year-end deadline for elections to reduce funding balances is unnecessarily restrictive and causes substantial hardship for plan sponsors that, for various reasons, miss the deadline. We believe that extending the deadline under the circumstances outlined above would not create any significant problems, and so we urge you to consider our request. We also ask that you consider our request to permit standing elections to reduce balances. Our preference, if we had to choose between the two options, would be to extend the

election deadline, as this offers the most flexibility, is easier to define from a regulatory perspective, and avoids possible unintended consequences that might result from a standing election.

Funding balances arise only because a plan sponsor has elected to make contributions in excess of minimum requirements. These balances should provide flexibility—not cause pain.

We appreciate the Treasury Department and the IRS giving consideration to these requests. 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.

Respectfully submitted,

A handwritten signature in blue ink that reads "Michael Pollack". The signature is written in a cursive style with a large initial "M" and a long, sweeping underline.

Michael F. Pollack, FSA, MAAA, EA, FCA
Chairperson, Pension Committee
American Academy of Actuaries