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(Submitted electronically)

Re: Increasing Flexibility Relating to Maintenance and Application of Funding Balances

Dear Mr. Weller and Mr. Ziegler,

The American Academy of Actuaries[1] Pension Committee respectfully submits for your consideration its comments and suggestions for modification to the rules relating to the maintenance and application of funding balances. The Pension Protection Act of 2006 ("PPA") has been in effect for over 10 years now. With the benefit of this experience, we are providing a number of suggestions, which we believe would improve these rules and help to avoid unintended consequences. Specifically we suggest:

- Extending the deadline for elections to create or apply funding balances by one month to coincide with the Form 5500 filing deadline;
- Extending the deadline for elections to reduce (waive) funding balances beyond the end of the plan year;
- Modifying specific and standing elections to provide greater flexibility by allowing formulaic elections; and
- To the extent that some of the above changes are not made, providing an additional standing election to waive funding balances under certain circumstances.

[1] The American Academy of Actuaries is a 19,500-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted 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.

Our observations of PPA over the past 10+ years makes clear that, despite comprehensive rules around funding balance elections, it is still far too easy for actuaries and plan sponsors to misunderstand the election rules and to miss deadlines, resulting in great frustration and unintended outcomes. This is particularly true for situations that do not occur every year, such as when a particular funding threshold must be achieved to avoid a Pension Benefit Guaranty Corporation (PBGC) §4010 filing or an at-risk status, or where a plan sponsor changes its intended contribution shortly before the final contribution deadline. Problems may also arise when information that would affect decisions around credit balance usage is not available until after the applicable deadline—for example, for short plan years, or when there is a change in Enrolled Actuary. In these cases, deadlines may be missed, potentially resulting in excise taxes, acceleration of contributions or additional reporting requirements, often through no fault of the plan sponsor and to no clear benefit to the plan participants.

We understand that the current rules reflect both statutory requirements, as well as concerns about how providing additional flexibility could complicate certain calculations—particularly the adjusted funding target attainment percentage (AFTAP), which affects proper plan administration. We believe that the changes that we are suggesting are fully consistent with the statutory requirements described in Internal Revenue Code Section 430 and can be made without complicating plan administration and without adverse consequences to plan participants. Such changes could help to reduce the administrative burdens that might have contributed many plan sponsors' decisions to exit the defined benefit system.

Some of the requested changes are consistent with those requested in the Pension Committee's letter of February 2012.[2] However, the committee has expanded on the list of suggested changes based on another nine years of experience and ask that you consider this expanded list of suggested modifications.

Extending the deadline to create or apply funding balances

The most helpful change to the election rules would be to extend the deadline for making these elections. Currently, elections to create or apply balances must be made by the final contribution due date, rather than the due date for the Schedule SB, which is one month later. Unfortunately, problems with these elections are sometimes not discovered until the Schedule SB filing is being prepared, at which point it is too late to make corrections. The penalty for a missed election to apply balances is an unpaid minimum required contribution, which triggers a 10% excise tax and which may trigger other reporting requirements, and violations of loan covenants. The penalty for failure to create funding balances is an unintended acceleration of contributions, which may trigger the need for additional borrowing or other severe business consequences. These penalties are disproportionate to the error—a failure to complete the intended paperwork. Because this

[2] Pension Committee letter to the Internal Revenue Service and Department of the Treasury addressing elections to reduce funding balances for defined benefit pension plans. (February 16, 2012) https://www.actuary.org/sites/default/files/files/publications/Academy-Letter-on-Funding-Balance-Elections.pdf.

paperwork is not filed with the government, but rather maintained internally by the plan sponsor, this framework could lead to some to try to "fix the problem" by backdating elections.

Fortunately, there is a simple solution to this problem. Extending the deadline by one month to coincide with the Schedule SB filing deadline would virtually eliminate this issue. Furthermore, such a change would not create any conflict with other deadlines or elections. We understand that this would move the deadline from before the nine-month mark (by which a final AFTAP or range AFTAP normally must be certified) to after that deadline. Nevertheless, under current rules the AFTAP may be certified earlier in the year (and often is) and existing rules concerning deemed waivers along with prohibitions against actions that result in a material change in the AFTAP could easily accommodate a one-month delay in these deadlines.

Extending the deadline for elections to reduce funding balances and to revoke excess usage of funding balances

This topic is covered extensively in the committee's 2012 letter referenced above. We believe that all of the arguments made in that letter still hold. To summarize briefly, the end-of-plan-year deadline to reduce or revoke excess usage of funding balances precedes deadlines for other requirements that are affected by the level of funding balances, thereby accelerating the decisions that need to be made in relation to meeting those requirements. In some cases (e.g., short plan years) the deadline may even precede the date that other needed information is available, as detailed in the referenced letter. As discussed in the 2012 letter and below, any conflicts that arise due to extending the deadline already exist to some degree under the current rules, and we believe they are manageable.

We observe that concerns about properly managing funding balances waivers have caused many sponsors to avoid creating these balances in the first place. Sponsors are reluctant to create these balances because they are subtracted from assets when calculating certain important funded ratios. In theory, sponsors always have the ability to waive funding balances, but the current timing rules can cause unintentional problems.[3] For example, in a short plan year or when requirements for the current year refer to the prior year's funded status ratios, it may be too late to apply a waiver by the time the issue is recognized. We have detailed a few examples below:

- **Short plan year**. A plan sponsor has a 2021 plan year from July 1, 2021, to June 30, 2022, and a short plan year in 2022 from July 1, 2022, to December 31, 2022. The final contribution for the 2021 plan year would be due on March 15, 2023, after the end of the short 2022 plan year, so if a standing election to create a prefunding balance (PFB) was in place, it would result in a PFB being created on March 15, 2023, and there would be no opportunity to waive the PFB as of July 1, 2022, under current rules. Even without an additional 2021 plan year contribution, the valuation results for the short 2022 plan year might not be final as of the waiver deadline for that plan year, in which case the sponsor

[3] We note that prefunding balances may also be undesirable for those plans that still have carryover balances, as these carryover balances receive preferential treatment but can be depleted more rapidly when plans maintain prefunding balances. For purposes of this letter, we generally do not address the additional issues raised by carryover balances.

would not be able to waive a previously existing PFB to achieve the target funded target attainment percentage (FTAP) as of July 1, 2022. If the waiver election were available until the Form 5500 is filed by October 15, 2023 (for the short 2022 plan year), this would allow time for a waiver of the prefunding balance previously existing or created by the standing election.

- **Credit balance usage threshold determination**. A plan sponsor must have an FTAP (reducing assets only by the PFB) of above 80% in the prior year—for example, as of January 1, 2019—in order to use funding balances to meet the minimum required contribution in the current year, for example, for the 2020 plan year. In this case, the plan sponsor would need to make the decision to waive any funding balances to keep the FTAP used for this purpose above 80% to be able to use the funding balances for the 2020 plan year. There is no opportunity to calculate, or perhaps even reasonably estimate, the 2020 minimum required contribution to determine whether the plan sponsor would want to be able to use funding balances to satisfy that contribution amount. In some cases, it is possible the FTAP is not even calculated by December 31, 2019 (e.g., if the plan is a frozen plan that does not require an AFTAP). This restriction applies infrequently, so it is possible for the actuary to miss checking the change in the FTAP after the final prior-year contribution was made and the prefunding balance was automatically applied to the funding balance. The inability for the plan sponsor to then use funding balances for the current plan year is a rather severe consequence when extension of the deadline could easily eliminate this potential problem.

- **At-risk threshold.** In a similar manner to the prior two examples, the at-risk threshold looks back to prior plan year FTAPs to determine whether at-risk restrictions will apply. While a plan is at-risk, the sponsor cannot prefund non-qualified deferred compensation for certain officers and other covered employees described in Code Section 162(m)(3). Because at-risk status is based on a look-back, by the time these restrictions apply, it is too late to waive funding balances, if possible, to avoid at-risk status. This restriction can be particularly problematic in the case of someone who becomes a covered employee during the year in which a plan is at-risk—particularly if the prefunding has already occurred. Extending the deadline for waiving funding balances does not necessarily solve this problem, but, where a waiver of funding balances could eliminate at-risk status, it does provide more time for plan sponsors to make this election. At-risk status may have other adverse consequences, such a violation of loan covenants. It is often the case that those individuals who are responsible for administering deferred compensation plans and compliance with loan covenants are not involved with the pension valuation and so may not be aware of the plan’s at-risk status. Again, extending the deadline will provide additional time to avoid an unintentional triggering of these adverse consequences.

We believe that there is no compelling reason for the deadline to reduce funding balances to precede the other funding balance-related deadlines for the plan year, such as the deadline to add prefunding balance. Therefore, we suggest that the deadline for reducing funding balances be

extended to coincide with the deadline for applying or creating funding balance. A more modest alternative would be to extend the deadline to three months following the close of the plan year. This change would avoid most of the concerns about potential overlap with other key deadlines but would still address many of the concerns cited in this letter and the 2012 letter.

Allowing formulaic elections

Current regulations require the precise amount of any election to be specified (or to be calculable based on known information) on the date of the election. Formulaic elections are expressly prohibited. We believe that formulaic elections could be permitted without creating undue complications and would allow funding balances to be applied in a manner that more clearly aligns with the sponsor's intent. We note that formulaic elections would not conflict with the statutory language, only with the current regulatory requirements.

For example, the standing election to apply balances to the quarterly contribution requirement could automatically apply only the minimum amount actually needed (25% of the lesser of 100% of the prior year minimum or 90% of the current year minimum), even before the current year minimum has been calculated.

The current regulations which permit standing elections applying funding balances to required quarterly installments limit their utility to plan sponsors. The standing election must blindly apply the safe-harbor quarterly amount equal to 25% of the prior year's minimum required contribution. When 90% of the current year's minimum required contribution is less than 100% of the prior year requirement, several actions are needed to prevent the use of more funding balance than necessary. Upon the realization that the safe harbor amount will no longer equal the final quarterly amount, the plan sponsor must suspend or revoke the standing election, modify it to use the appropriate amount for future quarterlies, if any. To the extent an amount in excess of the total minimum required contribution for the year has been applied by the standing election in place to that point, the sponsor must revoke the excess elected amount. Additionally, the revocation is due by the end of the plan year, which is prior to the due date for the final quarterly and also prior to the date when the valuation must otherwise be finalized. If the sponsor does not realize that the standing election has applied an amount in excess of the total minimum requirement until after the end of the year, the excess may not be recovered. We believe these shortcomings have led many sponsors and their advisers to conclude that the use of standing quarterly elections on balance do not add sufficient value to justify the effort.

An alternative approach would ensure that the sponsor meets quarterly election requirements with a minimum of paperwork as long as sufficient credit balance exists on the applicable deadline. This could increase the use of these simplifying elections and reduce the instances where a quarterly contribution is missed due only to the failure to complete the necessary paperwork. Easier use of credit balances might even increase the willingness of sponsors to prefund their plans. Prior to the completion of the current valuation, the application of funding balances could apply based on the safe harbor quarterly, with a retroactive and automatic adjustment after the current year's results are complete. The concern that funding balances might increase retroactively (or potentially fall in the case of a correction to current- or prior-year

valuation results) is still manageable given rules around funding balance waivers, which take precedence over elections to apply balances. In fact, there are already instances in which the credit balance applied to past quarterlies is adjusted retroactively, such as when a deemed or elective reduction in credit balance occurs in order to avoid benefit restrictions. This newly possible situation would just be one more example of that type of adjustment.

We see no reason why this concept cannot be extended to allow for other formulaic elections, as long as the amount in question is clearly defined with reference to amounts that are knowable (if not yet measured) as of the election date, such as the funding target, effective interest rate and the amount of the funding balances adjusted for any other elections that are treated as occurring on a prior date. Although the existence of deemed funding balance waivers should be sufficient to avoid any material change in the benefit restriction status under Code Section 436, these rules could include an additional failsafe that would limit the application of any formulaic election to the extent necessary to avoid a material change under §436.

Standing elections to reduce funding balances

In the absence of an extension of the deadline to reduce funding balances, an alternative approach that would address some of the shortcomings of the current rules would be to allow standing elections to reduce funding balances. While this approach is not preferred, it does avoid many of the potential concerns that would arise from extending the deadline into the next year. Potential approaches and considerations regarding standing elections to reduce funding balances were included in the 2012 letter and we continue to believe the rationale noted in that letter is applicable.

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We think that the rules addressed above in this letter can be greatly improved by providing more flexibility with respect to funding balance elections. Specifically, we believe that better outcomes could be achieved by providing additional time to make elections and by allowing greater flexibility through formulaic elections and/or additional standing elections. With these changes, the unintended consequences discussed above would be virtually eliminated, to the benefit of all concerned. Although these changes would require a revision to IRS regulations, we do not believe that they present any conflict with the statutory requirements themselves. Furthermore, we believe that these changes can be implemented without creating any inherent conflicts within the rules.

We appreciate the Treasury Department and the IRS giving consideration to these requests. Please contact Philip Maguire, the Academy's pension policy analyst (maguire@actuary.org), if you have any questions or would like to discuss these items further.

Respectfully submitted,

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Chairperson, Pension Committee
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