



AMERICAN ACADEMY of ACTUARIES

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Re: Potential Improvements in IRC §436 Benefit Restriction Rules

Dear Mr. Weller, Mr. Saunders and Ms. Kahn:

The American Academy of Actuaries' Pension Committee¹ is pleased to present the following comments regarding potential improvements in the operation of IRC §436. The Pension Committee is generally supportive of the aims of IRC §436. However, it is unnecessarily cumbersome in some respects and could be made easier to administer, easing the burden on plan sponsors, without undermining IRC §436's goal of protecting the funded status of pension plans and thereby protecting participant benefits.

Our comments fall into the following broad categories:

- Timing Issues
- Avoidance of Restrictions
- Application of Restrictions
- Conflicts with Collective Bargaining Agreements

Timing Issues

Among the more difficult aspects of IRC §436 from an administrative perspective are the timing rules surrounding imposing and lifting restrictions.

¹ The American Academy of Actuaries is an 18,000+ 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.

➤ *Changes in Benefit Restrictions*

Problem – Under IRC §436, benefit restrictions must be implemented or lifted as of the first annuity starting date (ASD) that falls after an Adjusted Funding Target Attainment Percentage (AFTAP) is certified that triggers a change. This requirement does not allow lead-time to modify election forms and systems and therefore does not allow for the normal election timeframes using those modified forms and systems. Election forms normally must be provided to participants at least 30 days before the ASD. However, plan administrators commonly provide them earlier so that trustees can set up an annuity for payment commencing on the chosen ASD (this typically requires at least two weeks advance notice). If the paperwork is provided to the participant only 30 days before the ASD, there is very little time for a participant to make a thoughtful decision and return the paperwork in time to actually receive a payment on the selected ASD.

Failure to provide lead-time between the certification of an AFTAP and the date when restrictions must be implemented (or lifted) results in participants being notified after they have already elected a particular option form that they can't receive it (or that they have additional options available). These participants may need to re-elect and wait (beyond the originally chosen ASD) to receive any payments.

Recommendation – To make this process easier, we suggest a grace period (e.g., 60-90 days) after an AFTAP is certified that changes the application of accelerated benefit restrictions. Of course, there is usually some warning before the certification of an AFTAP that changes benefit restrictions, so there is some opportunity for implementation planning, but the Internal Revenue Service (IRS) has indicated (in the preamble to the October 2009 final regulations) that delaying issuing an AFTAP (for the purpose of providing time for changes in administration, or for any other reason) once the AFTAP is otherwise ready to be certified raises issues of improper employer discretion over IRC §411(d)(6) protected benefits. Thus an explicit period to allow for administrative changes and the election process would be extremely helpful.

We believe that the requirement to provide notice to participants within 30 days after the AFTAP is certified should not change, so all potentially affected participants have the same knowledge of the change about to occur and can act accordingly. While “run on the bank” situations could exist, we expect that they would be unusual – it is unlikely most participants will give up their job significantly earlier than they otherwise would have to ensure payment of a lump sum – and thus would not warrant imposing difficult to administer processes in all situations. To limit runs on the bank, the grace period might be made not to apply to large payments (e.g., the portion of a lump sum in excess of like the smaller of \$250,000 or 1% of funding target).

➤ *Mergers or spin-offs*

Problem – When mergers or spin-offs occur, the IRS has indicated informally that the benefit restrictions applied should reflect the resulting plan or plans' funded status as soon as possible after the event. However, the funded status of the resulting plan(s) may not be immediately determinable, particularly for spin-offs where the plan is not

fully funded on a termination basis and assets must be allocated to successor plans in accordance with IRC §414(l), which follows ERISA §4044 —a process that can take months.

Recommendation – We recommend a grace period (e.g., 120 days) during which participants would remain subject to the same restrictions that would have applied had the event not occurred until the funded status of the merged or spun-off plan is certified. This treatment could be denied if the event was for the purpose of evading restrictions, in the same manner that current regulations disallow spin-offs while a plan is less than 80% funded if the spin-off is for the purpose of avoiding or terminating restrictions. This provision should also allow for a mid-year range certification (that need not be followed up with a specific AFTAP certification if the AFTAP or AFTAPs for the original plan(s) have been certified) *solely* for the purpose of specifying the range in which the AFTAP of the merged or spun-off plan falls.

➤ *Posting Security to Avoid Benefit Restrictions*

Problem – IRC §436(f)(1) allows for the posting of security to enable a plan to avoid certain benefit restrictions. However, the requirement in the regulations to have security in place by the valuation date of the plan year if it is to be reflected in the AFTAP makes that option generally unusable. The plan sponsor may not know whether security will be needed, and doesn't know the amount needed, by the valuation date. This deadline seems counterproductive, since the result is that security that otherwise might have been posted will not be posted, and if the plan terminates before the plan is well-funded enough to release the security, the participants and the Pension Benefit Guaranty Corporation (PBGC) will be in a worse position than if posting of the security had been facilitated.

Recommendation – We recommend that security be permitted to be posted at any time until the deadline for certifying the AFTAP that would reflect it. Posting of security should be treated in the same manner as an additional contribution for the preceding plan year. Thus an update to the AFTAP to reflect the posting of security would be deemed an immaterial change.

Avoidance of Restrictions

Certain methods of avoiding restrictions are more cumbersome than we believe they need to be. We discuss below the specific issues. While we acknowledge that some of these problems are resultant of statutory language, we ask that IRS consider whether any changes in regulations might alleviate some of the problems.

➤ *Contributions to Avoid Accelerated Benefit Restrictions*

Problem – IRC §436 contributions cannot directly be made to improve a plan's funded status to 60% or 80% to remove or to reduce accelerated benefit restrictions. We believe this prohibition is counterproductive, and that whenever any type of benefit restriction is in place or about to take effect, the plan sponsor should be able to avoid or immediately remove the restriction by contributing. In fact, the current rules produce anomalous results. For example, for a non-frozen plan with an AFTAP

below 60%, an IRC §436 contribution can be made to improve the AFTAP to 60% for the purpose of resuming accruals, but a consequence of that will be that accelerated benefits will change from being prohibited to being only partially restricted. A plan that was frozen after September 2005 (and is therefore not automatically exempt from accelerated benefit restrictions) could not make that same IRC §436 contribution and begin partially paying accelerated benefits, even though the risk to the PBGC would seem to be greater with a non-frozen plan.

Plan sponsors can often instead make regular IRC §430 contributions for the prior year to improve the AFTAP to 60% or 80%, but they can't if they decide to contribute after the deadline for making prior plan year contributions. Limiting the ability to "fund away" restrictions to the first 8-1/2 months of the plan year is counterproductive. In some situations the desire or ability to contribute may arise late in the year (e.g., triggered by a late-year merger or spin-off, an acquisition of a plan, the availability of cash, a desire for a current year deduction, or other events).

Recommendation – We recommend, if feasible, that the regulations be changed to permit plan sponsors to make an IRC §436 contribution to directly increase an AFTAP to 60% or 80%.

Extension of EPCRS Correction Approach to Standard Plan Operation

Problem – Under the Employee Plans Compliance Resolution System (EPCRS), if accelerated benefits are paid that should not have been paid, and they cannot be recovered from the participants, part of the correction is contributing the full amount of a lump sum that should not have been paid back to the plan. This leaves the plan better off than if the lump sum had not been paid since the liability to the participant has been extinguished with no reduction in plan assets. Allowing this treatment only through EPCRS is a moral hazard as it could encourage plan sponsors to "make mistakes" and pay benefits that should not have been paid and then fix them through EPCRS. Furthermore, it potentially harms participants, since in the EPCRS process participants need to be notified that the lump sums they received and do not return are not available for rollover to an Individual Retirement Account (IRA).

Recommendation – We believe the opportunity to fully fund the amount of a lump sum payment when a plan's AFTAP is less than 80% should be available as a general rule (not only through EPCRS). This treatment would need to be consistently applied; for example, if the AFTAP is at least 60%, a plan sponsor could be permitted to make lump sums available to *all* participants who terminated employment or commenced benefit payments from the date restrictions on accelerated distributions would otherwise have been first imposed by contributing the amount of the lump sums thus paid. Again, as this would improve the plan's funded status by extinguishing liability with no reduction in assets, there does not appear to us to be a public policy reason to disallow this approach. Of course, like any other IRC §436 contribution, such contribution would not count against the minimum required contribution nor would it be able to give rise to prefunding balance. Note that this recommendation is consistent with our suggestion above that plan sponsors be permitted to make §436 contributions to avoid accelerated distribution restrictions.

➤ *Improvement in EPCRS Process*

Problem – If a plan sponsor makes an inadvertent mistake that briefly imposes benefit restrictions (e.g., failing to have an AFTAP certified before April 1, when the presumed AFTAP drops below 80%, but having it certified above 80% during April) the error cannot be corrected without involving the participant, unless the plan sponsor convinces the IRS otherwise through EPCRS. The general rule is that the participant would be required to return the distribution to the plan, and then must re-apply and receive a distribution at a new ASD. If the participant did not comply with this administrative requirement, any rollover the participant made would be illegitimate, and tax problems would arise with respect to the participant's IRA.

Recommendation – The participant and plan sponsor should not be subject to this requirement when the plan sponsor is willing to quickly correct a mistake by contributing, and we suggest that the plan sponsor be allowed to do so with no ramifications to the participant.

➤ *Eliminating Restrictions When Presumed AFTAPs are in Effect*

Problem – Under current regulations, plan sponsors must go through a complicated process if they want to contribute to permit accelerated benefits while a presumed AFTAP is in effect. They must (i) accelerate the prior year's wrap-up contribution, (ii) make additional prior plan year contributions, (iii) create prefunding balance (PFB) with those additional contributions, and (iv) allow the funding balance to be forfeited to get the presumed AFTAP to 60% or 80%.

Recommendation – We recommend that the regulations be changed to permit plan sponsors to make an IRC §436 contribution to directly increase a presumed AFTAP to 60% or 80% without accelerating the prior year wrap-up contribution and creating and forfeiting funding balance.

➤ *New Plans*

Problem – If an employer adopts a new plan that is subject to accelerated benefit restrictions in its first year because it has a non-zero funding target (and thus has an AFTAP of 0% and no prior plan year for which to contribute to change the AFTAP), lump sums will not be payable in the first year even though the plan sponsor may be willing to immediately fully fund the plan. Many new plans have non-zero funding targets (e.g., because the plan provides past service benefits, or a wrap-around for participants spun off from a predecessor employer plan, or it provides disability or other ancillary benefits that will be partially attributed to periods before the valuation date by the required funding methodology in the IRC §430 regulations).

Recommendation – New plans should be permitted to make contributions in their first year that would be recognized when determining whether accelerated benefits can be paid. Note that allowing security to be posted after the valuation date is also a means of addressing this problem. However we would expect that in most situations a

contribution would be preferable since the amounts involved would typically be small and the problem disappears in the plan's second plan year so that the expense of setting up a surety bond or escrow account is not easily justified. As a public policy matter we believe that the formulation of new plans that grant past service benefits is something that should be encouraged.

➤ *Range Certifications and Amendments*

Problem – The IRS interprets its regulations to not permit an amendment to take effect while a range certification of at least 80% is in effect, unless the plan sponsor contributes 80% of the increase in the funding target caused by the amendment, even if the plan's AFTAP would be in excess of 80% reflecting the amendment.

Recommendation – We believe the regulations should be changed to permit the actuary to certify that the plan is at least 80% funded reflecting the amendment, to avoid delaying the effective date of the amendment until the valuation can be completed and a specific AFTAP is certified. The same rule should apply for unpredictable contingent event benefits (UCEBs) when a range certification of at least 60% but less than 80% is in effect; the actuary should be permitted to certify that the plan remains at least 60% funded after the UCEBs are paid.

➤ “Keep up with wages” exemption

Problem – The statute indicates that an amendment improving benefits in a flat dollar plan is exempt from testing “but only if the rate of such increase is not in excess of the contemporaneous rate of increase in average wages of participants covered by the amendment.” This provision was intended to put flat dollar benefit formulas (where past service benefits are increased only via plan amendments that must be tested under IRC §436 to determine whether they can take effect) on equal footing with final-average pay benefit formulas (where past service benefit increases occur automatically when a participant's final average pay increases).

In a common situation, a collective bargaining agreement (CBA) is negotiated with specified increases in hourly wage rates and pension benefit multipliers that take effect in each year of the CBA for all those employed at the effective date of the increase. The plan sponsor will generally want to structure the agreement so that the rate of increase in the multiplier does not exceed the rate of increase in the hourly pay rate, and thereby be sure that the CBA that is agreed to can actually be administered as written. However, the IRS's regulations surrounding testing of amendments in general, combined with the IRS's interpretation of “contemporaneous rate of increase in average wages,” effectively makes this impossible. The regulations require that those multiplier increases be tested in each future year as they take effect. At the same time, the IRS has indicated that the determination of whether the increases exceed the contemporaneous rate of increase in average wages must be evaluated by looking at **total** compensation paid, which is influenced by levels of overtime and other business related factors that the plan sponsor may have no direct control over and cannot predict several years in advance. As a result, a plan sponsor negotiating a CBA

cannot guarantee that the benefit multiplier increases they are agreeing to can take effect.

Recommendation - We believe that the regulations should be changed to permit the “contemporaneous rate of increase in average wages” to be determined using hourly base pay rates so that a plan sponsor can structure a CBA to ensure it is eligible for the “keep up with wages” testing exemption throughout its term.

Application of Restrictions

Problem – There are a number of IRS interpretations under IRC §436 that increase administrative effort in ways that seem disproportionate to the benefit involved and that can create seemingly unfair results for participants with smaller benefits.

Recommendations – We believe that the following relatively small changes in regulations would significantly ease administrative difficulties without having any material deleterious effects on the funded status of plans and would have positive effects on lower paid participants.

Social Security level income options – We suggest that Social Security level income options be excluded from the definition of accelerated benefits if the AFTAP is at least 60%. While it is true that level income options are in some cases equivalent to installment payments for a very short period, that is true only for people with small benefits, who are usually also lower paid, and represent a small portion of a plan’s overall liability. Distributions of such benefits will not significantly weaken plan funding and thus this restriction is disproportionately complicated to administer compared to the minimal benefit it provides (in terms of keeping cash in the plan). These restrictions can also have adverse effects on lower income participants who need to stop working before age 62 or 65 (e.g., for health reasons, or because they have physically demanding jobs they can no longer perform, etc.).

Small lump sums – The restriction on accelerated benefits when the AFTAP is at least 60% but less than 80% is applied to limit the acceleration to 50% of the total present value of the benefit, with no exception for smaller lump sums (other than lump sums under \$5,000). We believe that there is no strong benefit to the plan or the PBGC in restricting moderately sized lump sums, and we suggest that modest lump sums larger than \$5,000 (e.g., up to \$25,000, indexed with CPI) be unrestricted if the plan is at least 60% funded. This approach would also prevent administering a lot of small balances and multiple distribution dates for participants who would have preferred a single sum payment form.

Definition of Accelerated Benefits – The IRS employs a broad definition of accelerated benefits, and does not limit the application of restrictions to benefits that commenced as of an ASD at which restrictions were in effect, but also restricts the acceleration of benefits as of a later date (e.g., the participant’s death). For example, if a participant retires when benefit restrictions are not in effect and selects a years’ certain option that pays, on death, a lump sum equal to the present value of the remaining guaranteed payments the determination of whether the beneficiary’s

residual payout is restricted is made when the participant dies, rather than at the ASD when the optional form was chosen.

If restrictions were instead determined at the ASD when the participant's benefit starts, then if the AFTAP was at least 60% but less than 80%, a cash refund or commuted lump sum to a beneficiary would not be restricted since the expected present value of the death benefit would rarely exceed 50% of the total expected present value of the benefit. If the permissibility of the option is not determined at the participant's ASD, the participant would be selecting an option without knowing whether it will ultimately be paid as selected. Lastly, the acceleration under these options is typically very modest (i.e., the acceleration of a few years' payments) and handling a non-lump sum distribution can be difficult when the beneficiary is the estate. For these reasons we believe that the regulations should be modified to exempt the payments to beneficiaries under these options from accelerated benefit restrictions, to avoid significant inconvenience for participants and the plan sponsor in situations posing little financial risk to the plan or PBGC.

Conflicts with Collective Bargaining Agreements

Note that this section differs from the preceding sections in that it is not focused on administrative difficulties caused by IRC §436, but rather focuses on potential conflicts between §436 and the provisions of collective bargaining agreements.

IRC §436 can create a conflict between labor (contract) law and ERISA, where benefits that have been bargained are rendered null and void by IRC §436. IRC §436 can operate to simply deny the bargained benefits, rather than, for example, deferring the benefits until the funded status improves or requiring reopening negotiations to resolve the situation.

For example, a plan may provide an IRC §411(d)(6) protected plant shut-down benefit, but the plant shut-down benefit cannot be paid if an AFTAP of less than 60% has been certified before the shut-down date, unless additional contributions are made and the AFTAP is recertified at a sufficient level (reflecting the shut-down benefits) later during the same plan year.

One way to avoid these situations, while at the same time avoiding the additional risk to the PBGC that plan amendments and plant shut-down benefits can pose when paid from poorly funded plans, is to change, for collectively bargained plans, the manner in which these restrictions apply. Under the current regulations, if benefit restrictions are not lifted during the year in which an amendment or a plant closing triggering UCEBs occurs, the benefits will simply not be paid (except in the case of a plan amendment that by its terms is "evergreen"), rather than simply being deferred until the funded status improves. We suggest that the period during which the lifting of restrictions would cause payment of benefits for collectively bargained plans be extended from one year to five years. This strikes a balance between concern for eliminating negotiated benefits and practicality (i.e., avoiding the need to go back many years and provide additional benefits). For example, plant closing benefits that were not paid would be paid if, within 5 years of the date the payments would otherwise have been made, the AFTAP was certified at a level

sufficiently above 60% so that it would remain at least 60% if the plant shut-down benefits were included, without the need for an amendment (and associated IRC §436 contributions if the AFTAP would be less than 80% reflecting the benefits).

In addition, fixing the “keep up with wages” methodology as discussed above would enable a CBA to be structured in a manner to guarantee it meets the exemption from testing as each multiplier increase takes effect, so that the benefits that are bargained can be paid.

We also believe that the regulations should permit a collectively bargained plan to provide that accruals that ceased while the AFTAP was under 60% are *automatically* restored without need for an amendment when the AFTAP (reflecting those accruals) is at least 60%. For this purpose, previously suspended accruals would be considered for each plan year separately. Full accruals would be restored for as many plan years as possible without reducing the AFTAP below 60%, with the earliest years of suspended accruals restored first. Under current rules, such a plan provision can only take effect if the accrual cessation was in effect for less than 12 months.

Benefits subject to restoration as described above would be subject to §IRC §411(d)(6) protection only when they are restored, and thus could be amended out of the plan before that date. Any such amendment would typically be subject to bargaining, and so the deferral of §411(d)(6) protection raises fewer concerns than the automatic elimination of these benefits under IRC §436.

The American Academy of Actuaries' Pension Committee appreciates the opportunity to comment on these issues and would be happy to discuss any of these items with you at your convenience. Please contact Matthew Mulling, pension policy analyst (mulling@actuary.org; 202-223-8196) if have any questions or would like to discuss these items further.

Sincerely,

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