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Comments on Technical Corrections to Pension Protection Act (H.R. 3361)

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United States House of Representatives

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The American Society of Pension Professionals & Actuaries (ASPPA) appreciates this opportunity to comment to the House Committee on Ways and Means on pending and new (still needed) technical corrections to the Pension Protection Act of 2006 (PPA). Improving upon PPA is crucial to fulfilling Congress' intention of strengthening the retirement security of the millions of working Americans who participate in employer-sponsored qualified retirement plans. Accordingly, ASPPA strongly supports timely enactment of the pending technical corrections bill (H.R. 3361).

ASPPA is a national organization of over 6,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants, investment professionals, and attorneys. Our large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse but united by a common dedication to the private retirement plan system.

There are a significant number of technical and other corrections needed to ensure that the Congressional goals of the PPA are fulfilled and that there is an efficient implementation of the provisions of PPA. Many of these corrections are addressed in the pending PPA technical corrections bill (H.R. 3361), which ASPPA supports. However, ASPPA also recommends that the bill be modified to address the following 9 issues, which are of particular importance to small and medium-sized qualified plan sponsors.

1. "Funding Whipsaw" (PPA §113)

Participant accounts in a cash balance plan accumulate in a manner similar to a defined contribution plan. Specifically, a participant's current balance in a cash balance plan is the sum of: (1) the prior year's balance, plus (2) the current year's pay credit (essentially a percent of compensation "contribution"), plus (3) the interest credit on the prior year's balance (this "interest crediting rate" is defined by the plan).

However, because a cash balance plan is a defined benefit plan, it is subject to the minimum funding requirements of Internal Revenue Code (Code) §430 and ERISA §303, as well as the benefit restrictions of Code §436 and ERISA §206, as enacted by the PPA. Code §430 and

ERISA §303 provide rules for determining a plan's "funding target" (or present value of benefits accrued.) In the case of a cash balance plan, this calculation requires (a) projecting forward the current account balances to retirement age at the plan's interest crediting rate then (b) discounting back (converting) to the current date using the appropriate yield curve interest rate.

This "back and forth" using two different interest rates can produce a distortion ("funding whipsaw") so that the "funding target" as defined by the PPA no longer bears any relationship to the sum of the current participants' account balances.

Code §436 and ERISA §206, as enacted by PPA, impose certain benefit restrictions on plan amendments, accruals or distribution options, applicable to single-employer defined benefit plans. In general, these provisions restrict distributions to plan participants to a monthly life annuity if a plan's funding is below 80% of its "funding target." Furthermore, these provisions require a freezing of benefits if the funding of the plan is below 60% of its "funding target."

Pursuant to Code §430(d) and ERISA §303(d), a plan's "funding target" is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year (using PPA mandated mortality and yield curve interest rate assumptions.)[1]

Code §411(a)(13)(A) and ERISA §203(f)(1) provide that an applicable defined benefit plan (hybrid plan) can pay lump sum benefits equal to hypothetical account balances without violating age discrimination rules of ERISA and the Code. This treatment is available as long as the plan credits interest on theoretical balances at a rate not to exceed a market rate of return.

PPA sought to encourage the establishment and maintenance of hybrid defined benefit plans by removing the most significant hurdles faced by these plans. PPA provided relief from the participant whipsaw effect, encouraging employers to provide a reasonable "market" rate of return to participants. PPA further removed uncertainty as to the application of age discrimination rules with respect to these plans.

An unintended result of the interaction of the elimination of the participant whipsaw rules with the benefit restriction rules is that a cash balance plan that has more than enough money to pay lump sums to all its participants, may nevertheless be restricted from actually paying lump sums to any of its participants. Thus, even though PPA permits an applicable defined benefit plan to credit participant accounts with a "market rate of return," the use of a market rate of return for cash balance plans will be unworkable because of the "funding whipsaw." This result is contrary to the intent of Congress in eliminating the participant whipsaw problem which allowed plans, for the first time, to credit participants' accounts at market rates without consequences.

Recommendation:

[1] Code §430(g) and ERISA §303(g) provide an exception for small plans (with 100 or fewer participants) to designate any date during the plan year as its valuation date for the plan year and succeeding years.

Accordingly, ASPPA recommends a technical correction to PPA regarding the trigger for benefit restrictions as they apply to an applicable defined benefit ("cash balance") plan. This change would affect only the benefit restriction provision and would not impact the determination of the required contribution.

The proposal would limit the funding target (for benefit restriction purposes only) with respect to cash balance accounts to the balance of the participants' theoretical accounts. In this way, the plan's funding target will not exceed the plan's total liability for benefits on a termination basis at the valuation date.

Under the following suggested legislative language, Code §436(j)(1) and ERISA §206(g)(9)(A) would be amended to modify the definition of "funding target attainment percentage" applicable to benefit restrictions:

Code § 436(j)(1) would be amended to add the following sentence to the end thereof:

> "However, for purposes of this section, with respect to any accrued benefits defined as the balance of a theoretical account, the funding target, as defined in Code §430(d)(1), shall take into account the lesser of the present value of the benefits accrued or earned as determined under Code §430 and the sum of the balances of such theoretical accounts."

ERISA § 206(g)(9)(A) would be amended to add the following sentence to the end thereof:

> "However, for purposes of this section, with respect to any accrued benefits defined as the balance of a theoretical account, the funding target, as defined in ERISA §303(d)(1), shall take into account the lesser of the present value of the benefits accrued or earned as determined under ERISA §303 and the sum of the balances of such theoretical accounts."

2. Benefit Restrictions—End of Year Plan Valuations for Small Plans (PPA §113)

Another problem with the AFTAP restriction is an issue related to end of year plan valuations for small plans. As referred to above, PPA §113 provides that benefit restrictions will be triggered if a defined benefit plan's Adjusted Funding Target Attainment Percentage (AFTAP) falls below certain specified percentages. PPA requires that certain restrictions arise if the plan's AFTAP is less than 80%; other benefit restrictions apply if the plan's AFTAP is less than 60%. PPA §113(h) provides that if an actuary has not yet certified the plan's AFTAP, it is assumed to be the same as last year. It further provides that where the plan's AFTAP has not been certified by the first day of the fourth month of the plan year (April 1 for calendar year plans), and the plan was within 10 percentage points of the restriction trigger in the prior year, the AFTAP is assumed to be 10% less than the prior year, triggering the restriction. Finally, where the plan's AFTAP is still not certified by the first day of the tenth month of the plan year (October 1 for calendar year plans), the plan is permanently deemed to have an AFTAP of less than 60% for the plan year. Accordingly, even where the AFTAP for the year is later determined to be greater than 60%, the less than 60% "deemed AFTAP" is still binding for the year. Thus, the resulting benefit accrual freeze remains in place until the next year's AFTAP is determined.

These requirements present particular problems for end-of-year plan valuations. First, the plan's AFTAP cannot be determined until the valuation date. The demographic and financial data used to determine the plan's valuation and funding level for a plan year is not available until the last day of the plan year and, thus, cannot be determined in time to avoid the "deemed AFTAP" of less than 60% and the resulting benefit accrual freeze. In addition, the AFTAP cannot be estimated effectively since the interest rates to determine the AFTAP on December 31 are not yet published as of October 1.

Recommendation:

H.R. 3361 would amend ERISA §206(g) and Code §436(j) to provide that the Secretary of the Treasury may prescribe rules for the application of the benefit restrictions which are necessary to reflect the alternate valuation date.

Instead of this provision in H.R.3361, Treasury should be given authority to avoid double-counting of assets or liabilities for determination of end of year AFTAP. Furthermore, ASPPA suggests the following legislative language to provide a look-back rule for small plans:

ERISA §206(g) of ERISA is amended by redesignating paragraph (10) as paragraph (11) and by inserting after paragraph (9) the following new paragraph:

> "(10) LOOKBACK RULE FOR SMALL PLANS.—In the case of small plans which are allowed to designate a valuation date any day of the plan year (pursuant to ERISA §303(g)), a small plan's AFTAP for purposes of the benefit restrictions would be determined as of the plan valuation date, coincident or immediately preceding the first day of the plan year. Furthermore, for determining a plan's AFTAP for valuation date other than the first day of the plan year, the funding target would include the target normal cost for the year, and the plan assets would include any contributions for the plan year which have been made by the certification date."

Code §436 should be amended by redesignating subsection (k) as subsection (l) and inserting after subsection (j) the following subsection:

> "(k) LOOKBACK RULE FOR SMALL PLANS.—In the case of small plans which are allowed to designate a valuation date any day of the plan year (pursuant to Code §430(g)), a small plan's AFTAP for purposes of the benefit restrictions would be determined as of the plan valuation date, coincident or immediately preceding the first day of the plan year. Furthermore, for determining a plan's AFTAP for valuation date other than the first day of the plan year, the funding target would include the target normal cost for the year, and the plan assets would include any contributions for the plan year which have been made by the certification date."

3. Plan Terminations – Lump Sum Distributions (PPA §113)

As stated above, PPA added Code §436 and ERISA §206, which, in part, restricts the forms of benefits which may be paid under certain underfunded plans and prohibits these underfunded plans from settling participant benefits through the purchase of annuity contracts. PPA failed to provide an exception to these rules in the event of plan termination.

There are two situations in which a sponsor may terminate an underfunded plan, even if the plan does not have sufficient assets to cover its benefit liabilities. First, a sponsor of a defined benefit plan that is not covered by the PBGC is permitted to terminate its plan at any time and provide benefits to plan participants only to the extent funded. Second, a sponsor of a defined benefit plan that is covered by the PBGC is permitted to terminate its plan if the majority owner of the sponsor agrees to waive his/her benefit to the extent necessary to allow the plan to meet its benefit obligations.

If a plan's funding is less than 80% of its "funding target," then the rules under Code §436 and ERISA §206 will prevent the plan from terminating by eliminating both possible settlement options; payment of lump sums and the purchase of annuity contracts.

This was an unintended consequence of PPA that must be remedied. Nowhere in PPA or the legislative history of PPA is there any indication that PPA intended to require small employers to fund benefits for the company's owner to the detriment of the company's financial health. Without a technical correction, it would be otherwise impossible to terminate these plans.

Recommendation:

ASPPA recommends that the benefit restrictions of PPA not apply in the year of plan termination. The easiest manner of correction would be to amend Code §436 and ERISA §206 to provide that the benefit restriction on accelerated forms does not apply with respect to benefits which are payable pursuant to any non-distress plan termination.

4. PPA Effective Dates

PPA contains many provisions with specified effective dates. Given the need for comprehensive regulatory guidance in order to implement many of these PPA provisions, as well as time to assimilate the regulations and consult with plan sponsors, it is necessary to postpone the effective dates of some of the PPA provisions.

One example is the funding rules. In order for actuaries and consultants to properly advise clients on the impact of the funding rules, the IRS must issue regulations detailing the application of the PPA changes for 2008 and beyond, as well as the application of the transition rules. The transition rules are based on the funded status of the plan for 2007 under the funding standards of PPA. 2007 valuations were not performed based on the PPA rules, but rather were subject to the pre-PPA rules. Without IRS guidance, a plan cannot determine its eligibility for the transition rules. Further, employers cannot make informed decisions as to their 2007 contribution strategy without knowing its impact in 2008 and beyond. At this time, no guidance has been issued, and therefore there is not sufficient time to react to any regulations that may be issued prior to the 2008 plan year.

On October 17, 2007, Rep. Earl Pomeroy (D-ND) and Rep. Eric Cantor (R-VA) introduced H.R. 3868, a bill that would delay for at least one year (until January 1, 2009) the effective date of the final PPA pension funding rules, minimum lump sum calculations and benefit restriction rules. For such regulations that have not been finalized by June 30 of the preceding year, H.R. 3868 would provide an additional delay of the effective date. ASPPA fully supports this legislation, which would allow plan sponsors, service providers and actuaries to comply with the new PPA rules with reliance on well-reasoned and comprehensive final guidance.

Recommendation:
ASPPA recommends that H.R. 3868, which would delay certain PPA effective dates by at least one year, be included in any current tax legislation currently under consideration by the Ways and Means Committee.

Alternative, to ensure that employers have sufficient time to assess their alternatives, ASPPA recommends that the effective date of the PPA funding rules, benefit restriction rules and Code §417(e) rules that impose additional restrictions or requirements on plan sponsors not be effective until the first day of the plan year beginning at least 180 days following the issuance of final regulations by the IRS.

5. Combined Plan Limit (PPA §803)

PPA §803 creates an exemption from the limit under Code §404(a)(7) on the deductibility of employer contributions when an employer maintains both a Defined Benefit (DB) and a Defined Contribution (DC) plan. The exemption eliminates the combined plan limit deduction requirement when an employer that maintains a DB plan and contributes six percent or less of aggregate compensation to a DC plan. In Notice 2007-28, IRS interpreted this relief to apply only to the operation of the limit on the DC plan. The result is that many sponsors of DB and DC plans will not get the benefit of the combined plan limit relief with respect to their DB plan contributions, particularly with respect to the PPA-provided ability to fund the DB plan up to150 percent of unfunded current liability. Affected plan sponsors and Congressional staff involved in the PPA conference negotiations believe PPA §803 was intended to apply to both the DB and DC portions of the plan.

Recommendation:

H.R. 3361 clarifies PPA §803 to provide that the exemption under Code §404(a)(7) from the combined plan deduction limit for employers who sponsor both DB and DC plans apply to both the DB and DC plan contributions. In addition, H.R. 3361 clarifies, contrary to IRS guidance (Notice 2007-28, 2007-14 I.R.B. 880), that if defined contributions are less than six percent of compensation, the defined benefit plan is not subject to the overall deduction limit. If defined contributions exceed six percent of compensation, only defined contributions in excess of six percent are counted toward the overall deduction limit.

ASPPA is very supportive of this provision in H.R. 3361, which will allow both workers and employers to increase their contributions to their retirement plans, resulting in greater retirement security for all American workers.

6. Fixed Rate for Computing Code §415 Limit on Lump Sum Payments (PPA §303)

PPA §303 sets the interest rate for determining whether a lump sum benefit payment exceeds the benefit limitations of Code §415. Under PPA, the rate will be the greater of a fixed 5.5 percent rate, a rate that produces a benefit of not more than 105 percent of the benefit provided from the applicable interest rate (as determined under the yield curve rules) or the plan rate. Prior to PPA, the Pension Funding Equity Act of 2004 (PFEA) enacted a temporary rate of the greater of 5.5 percent or the plan rate.

The purpose of the fixed 5.5 percent rate enacted under PFEA was to give small plan sponsors simplicity and predictability in calculating their funding requirements for purposes of their lump sum payment liabilities, particularly when business owners or key employees approach retirement age and commence the payment of plan benefits. Inclusion of the "105 percent" prong of the "greater of" test functionally eliminates this certainty. The fixed 5.5 percent rate is a conservative approximation of historically applicable rates and is necessary for small plan sponsors to plan and fund for their liabilities as their key workers retire.

ASPPA recommends that Code §415(b)(2)(E) be amended to reflect PFEA and require the Code §415 lump sum calculation to be the greater of 5.5 percent or the plan's stated interest rate. Using a flat interest rate removes volatility for determining lump sums (the most prominent form of payment) and ensures planning consistency, thereby encouraging the establishment of new defined benefit plans by small businesses.

Suggested legislative language:

SEC. 303. Interest Rate Assumption for Applying Benefit Limitations to Lump Sum Distributions.

> (a) IN GENERAL.--Clause (ii) of section 415(b)(2)(E) of the Internal Revenue Code of 1986 is amended to read as follows:
>
> "(ii) For purposes of adjusting any benefit under subparagraph (B) for any form of benefit subject to section 417(e)(3), the interest rate assumption shall be the greater of:
>
> "(I) 5.5 percent, or
> "(II) the rate specified under the plan."

7. Benefit Statements—Calculation of Permitted Disparity (PPA §508)

PPA §508(a) amended ERISA §105, making a number of significant changes to the pension benefit statement requirements for both individual account plans and defined benefit plans. One of the requirements under PPA §508 is that a pension benefit statement include "an explanation of any permitted disparity under section 401(l) of [the Code] or any floor-offset arrangement that may be applied in determining any accrued benefits." This language could be interpreted to require that defined contribution plans, as well as defined benefit plans, include this disclosure on pension benefit statements to the extent that permitted disparity is included as a plan feature.

Under a defined contribution plan, it is unclear whether the use of permitted disparity in determining how contributions are *allocated* among plan participants directly affects the determination of any accrued benefit. Furthermore, this requirement is duplicative as a defined contribution plan's use of permitted disparity in allocating plan contributions is already required to be disclosed in plain English as part of the plan's Summary Plan Description.

For defined benefit plans, permitted disparity in generally used in one of two ways. The first situation involves a plan with a benefit formula designed specifically to conform to the requirements of Code §401(l), where the availability of Social Security benefits or the disparity in taxation under FICA for higher-paid vs. lower-paid employees is part of the benefit formula. The second type of permitted disparity use does not take into account Social Security or covered compensation in the plan's benefit formula, and Code §401(l) is not relevant in determining plan benefits.

In order to comply with the requirement of PPA to explain the impact of Code §401(l), any statement on permitted disparity would need to contain a description of the concept and reasoning behind permitted disparity and then contain a glossary to define the concepts of covered compensation and the Social Security taxable wage base. It is likely that this "explanation" will make the participant statement unnecessarily complex for the average participant.

Recommendation:

ASPPA recommends that PPA be amended to exclude any disclosure of permitted disparity under Code §401(l) for defined contribution plans. For defined benefit plans, ASPPA recommends that permitted disparity only be required to be disclosed on participant statements if the plan's benefit formula directly references permitted disparity that is designed to comply with Code §401(l). Further, we recommend that to the extent such disclosure is required, that PPA §508(a) be amended to permit the employee benefit statement to simply include a reference to the section of the Summary Plan Description that describes the benefit formula where the plan uses permitted disparity to determine benefits..

8. DB(k) Plans (PPA §903)

PPA §903 creates, beginning in 2010, a new plan design called an "eligible combined plan" [commonly referred to as a "DB(k)"] available to employers with 500 or fewer participants. The DB(k) plan design allows a qualifying employer to establish a combined DB and 401(k) plan, using one plan document, one summary plan description, one Form 5500, and one audit (if required). The DB(k) would be deemed not top-heavy or subject to non-discrimination testing where it meets specific safe harbor formulas for both the DB and the 401(k) elements of the plan. The DB component is either a 1% of final average pay formula for up to 20 years of service, or a cash balance formula that increases with the participant's age. The 401(k) component would include an automatic enrollment feature (using 4% as the automatic enrollment rate), and provide for a fully vested match of 50% on the first 4% deferred.

ASPPA is concerned that PPA §903 restricts the availability of the DB(k) plan option to situations where the employer is willing/able to contribute amounts to the DB and 401(k) component other than specified under the safe harbor and be willing to meets its nondiscrimination obligations through general nondiscrimination rules (ADP/ACP) and top-heavy testing procedures. Because of unique workforce demographics or other reasons, some small employers will prefer to use the usual nondiscrimination rules available under current law, which could result in even more generous contributions on behalf of rank-and-file workers. The required use of the safe harbor in PPA §903 could prevent these employers from offering the DB(k) plan option, which combines the best elements of the DB and 401(k) plan designs.

With regard to DB(k) plans that utilize a cash balance formula, the statute prescribes a minimum cash balance formula, and allows for modifications to that formula within certain parameters. Under certain circumstances, it is possible that the statutory formula would fail to satisfy the minimum accrual requirements under Code §411(b). Legislative language is needed to ensure that the minimum benefit formula prescribed by the statute will be deemed to pass the minimum accrual standards of Code §411(b).

Recommendation:

ASPPA recommends that PPA §903 be amended to permit the use of all defined contribution formulas and 401(k) matching arrangements as allowed under current law. Accordingly, a DB(k) plan sponsor should be able to choose either the provided safe harbor or the regular nondiscrimination rules and top-heavy testing rules when testing the DB and DC components of the DB(k) plan. Further, we recommend that any benefit formula used will be deemed to pass the minimum accrual standards of Code §411(b).

9. Tribal Plans Treated as Governmental Plans (PPA §906)

PPA §906 imposes new restrictions on the treatment of qualified retirement plans maintained by Indian Tribes as governmental plans for purposes of ERISA. PPA limits the governmental plan treatment of tribal plans to situations where the sponsoring tribes earn no income from “commercial activity.” As drafted, the “commercial activity” language is very broad. Further, Treasury’s Notice 2006-89 adopts such a broad definition of “commercial activity” as to make it very difficult for a tribal government to sponsor a qualified plan under ERISA governmental plan rules. The result is to eliminate government plan treatment for any tribal government that engages in any income-producing activity, no matter how small or no matter how related that activity is to the tribal government’s core functions.

Recommendation:

ASPPA recommends PPA §906 be amended to treat all retirement plans maintained by Indian tribes as governmental plans. Indian tribes are in fact governments in all respects. Their plans can and should be adequately governed under the usual governmental plan rules in both ERISA and the Internal Revenue Code.

Conclusion

Thank you for this opportunity to submit a statement to the Ways & Means Committee on these very important issues. ASPPA pledges to you its full support in creating the best possible PPA corrections legislation.