AMERICAN BENEFITS
COUNCIL

April 15, 2014

Mr. George Bostick
Benefits Tax Counsel
Office of Tax Policy
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington DC 20220

RE: Liquidity Shortfall/Funding Regulations (REG-108508-08)

Dear Mr. Bostick:

On behalf of the American Benefits Council (the "Council"), I am writing to call your attention to a concern relating to a proposed pension funding regulation. As it appears the regulation may be finalized very soon, we believe action is required quickly to avoid a very serious problem with respect to the liquidity shortfall contribution. We very much appreciate the enormous amount of great work that Treasury and the Service have done implementing the funding rules. The guidance has helped facilitate a smooth transition to an extensive set of new rules. Fixing the problem with respect to the liquidity shortfall contribution is an important part of continuing that workable transition.

The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans that cover more than 100 million Americans.

The problem relates to the question of whether the liquidity shortfall contribution continues to be required after there is no longer a liquidity shortfall. Under a long-standing interpretation of the statutory rule, a contribution is no longer required if the shortfall disappears, regardless of the reason. This is consistent with the statutory provision that the shortfall is "treated as unpaid until the close of the quarter in which

the due date for such installment occurs." Internal Revenue Code (Code) Section 430(j)(4)(C).

The shortfall often disappears due to a variety of factors, such as reduced expenses, favorable investment earnings, plan mergers, and contributions pursuant to the usual funding rules. In cases where the liquidity shortfall has not been made, but there is no longer a shortfall, the Code provides for an excise tax which may be waived in cases of good reason, and there are numerous private letter rulings waiving the excise tax in cases where it is appropriate not to punish the sponsor of the pension plan.

Unfortunately, the proposed regulation, Section 1.430(j)-1(f), Example 11, Paragraph (iii), states that in these cases, the contribution continues to be required even though the shortfall no longer exists, contrary to the applicable statutory language quoted above. Application of such a rule would lead to plan sponsors having to make disproportionate contributions, in many cases contributing for the exact same shortfall multiple times. This is not consistent with the statute, prior interpretations of the same language, or sound administration of the law.

For example, if a plan had a $1 million shortfall for three successive quarters, the required contribution would be $3 million notwithstanding the fact that the shortfall was never more than $1 million. In other words, a $3 million contribution could be required for a shortfall that is only $1 million, or in some cases may no longer exist at all.

We understand that the basis for this change in the law is the new "ordering rule" in Code Section 4971. However, we believe this is a misreading of the ordering rule, which by its terms applies only to sections 4971(a) and (b) (unpaid contributions for a plan year) and not to the liquidity shortfall which is in Section 4971(f) (unpaid installment for a quarter).

I am enclosing a comment letter that was filed in 2011 by a group of prominent actuaries calling attention to this problem. The comment letter provides additional detail as to the problem and the statutory basis for changing the proposed regulation.

Please feel free to contact me if you have questions regarding this issue. As always, we appreciate your work on these complex regulations.

Sincerely,

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January 5, 2011

CC:PA:LPD:PR (REG-108508-08)
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VIA: notice.comments@irscounsel.treas.gov

Re: Proposed Regulation relating to Liquidity Shortfall Contribution
REG-108508-08

On behalf of the signatories listed below, we are writing to point out an error in the proposed regulation referenced above and to request that it be corrected before the regulation is finalized. Before explaining the error, we wish to acknowledge that the Treasury Department has done a tremendous job of issuing hundreds of pages of necessary regulations to implement the Pension Protection Act of 2006, and did so under extremely tight deadlines. We are grateful for the efforts of Treasury to provide the guidance that was necessary for the continuing administration of defined benefit pension plans in the U.S. Within that mountain of regulatory guidance, we have found what we believe to be an error in the interpretation of a rather obscure provision: the liquidity shortfall contribution requirement.

Specifically, § 1.430(j)-1(f) Example 11 paragraph (iii) states that the liquidity shortfall contribution accumulates and pyramids if it is not made by the end of the quarter in which it is due. ("[The liquidity shortfall as of June 30, 2009] is required to be paid in addition to the unpaid liquidity shortfall contribution due April 15, 2009.") This is not a correct statement of the statutory provisions for the liquidity shortfall contribution in cases where it is unpaid. If the proposed regulation is finalized in this form, it will create havoc in the administration of defined benefit plans and result in the unnecessary and punitive acceleration of funding requirements, in many cases for employers who are least able to sustain such accelerations. We hope that there is still time to correct this error before the regulation is finalized.

Background

In simplified form, the liquidity shortfall rules in § 430(j)(4) of the Internal Revenue Code ("Code") require that a pension plan have sufficient liquid assets to pay 3 years worth of benefit payments. The liquidity shortfall is measured every quarter. If a liquidity shortfall occurs

as of March 31, for example, the plan sponsor has 15 days (until April 15) in which to make a contribution of liquid assets to make up the shortfall. If the contribution is not made within that 15 day period, the following consequences occur:

- There is a 10% excise tax under Code § 4971(f) on the unpaid amount.
- The plan sponsor is required to notify the PBGC, which then has a lien.
- The plan must stop paying certain accelerated benefits, including lump sums.
- There is an additional interest charge as a required contribution, carrying interest on the unpaid amount to the end of the quarter (June 30).
- If there is still a liquidity shortfall at the end of the quarter (June 30) there is a new liquidity contribution required on or before July 15.
- If the liquidity shortfall persists for 5 consecutive quarters, the excise tax increases to 100%.

However, the payment due on July 15 is instead of, and not in addition to, the contribution required on April 15 (although a new excise tax arises for the July 15 shortfall, if it is not made). The liquidity shortfall, and the consequent contribution requirement, disappears on June 30, and is replaced by a new liquidity shortfall. The logic of this result is compelling, as well as mandated by the statute. To see why, consider this very simplified example.

Plan A pays out annuity benefits of $1 million per quarter, or $4 million per year. The "base amount" (3 times a year's benefit payments) is $12 million. Plan A has assets of $20 million but liquid assets of only $11 million as of March 31. The liquidity shortfall contribution due on April 15 is $1 million.

If Sponsor A fails to make the $1 million contribution on April 15, it will have to pay an excise tax of $100,000, in addition to the eventual contributions necessary to fund the plan. If no contributions are made, no assets are liquidated, and there are no investment earnings, Plan A will have $10 million in liquid assets on June 30 and a new liquidity shortfall due July 15 of $2 million. By September 30, the liquid assets will be $9 million and the liquidity shortfall contribution due October 15 will be $3 million.

In other words, the liquidity shortfall contribution accumulates naturally if allowed to play out as the directed by the statute. In addition, if the plan sponsor still has not made a contribution by October 15, the excise tax will be up to $600,000 and the PBGC may well have intervened. By April 15 of the following year, if no contribution has been made and a liquidity shortfall still persists, the excise tax increases from 10% to 100%. Thus, no additional imperative is needed to give Sponsor A an incentive to make the liquidity shortfall contribution.

However, under the proposed regulation cited above, Sponsor A would now be required to contribute $6 million ($1 million plus $2 million plus $3 million). This $6 million contribution

requirement is punitive, because the actual shortfall is only $3 million. And, unlike the excise tax, the contribution requirement cannot be waived under the regulation.

Further, it is often the case that a liquidity shortfall disappears naturally, and no contribution is required at all. For example, suppose Plan A, in the example above, discovers a liquidity shortfall on March 31 of $1 million. In order to correct the shortfall, Plan A sells the $9 million in non-liquid assets[1] and increases the Plan's liquid assets to $20 million. It will still have a contribution requirement until June 30, and that contribution requirement may be enforced by the PBGC.

Statutory Basis and Pre-PPA Rulings

Under Code § 430(j)(4)(C) the liquidity shortfall contribution is "treated as unpaid until the close of the quarter in which the due date for such installment occurs." At the end of the quarter, the old liquidity shortfall essentially disappears, and is replaced with a new liquidity shortfall. If there is no shortfall at the end of the next quarter, there is also no contribution required.

The same statutory language appeared, before the Pension Protection Act, in Code § 412. The fact that the liquidity shortfall contribution disappears when the liquidity shortfall itself disappears (for whatever reason), was recognized both in the statute and in the rulings. For example, the liquidity shortfall contribution was never added as a charge to the funding standard account. Therefore, if not made, it would not carry over into the next year.

In addition, Private Letter Rulings by the IRS (waiving the 4971 excise tax) recognized that the liquidity shortfall contribution requirement disappeared when the shortfall itself disappeared. An example is PLR 200724038, in which the 10% and 100% excise taxes were waived because the shortfalls were due to reasonable cause and proper remedial steps were taken. In this PLR, the employer was never aware of the liquidity shortfall until after it no longer existed. That is, a surge in benefit payments created the shortfall, and when that surge dropped out of the 12 month trailing average of benefit payments, the liquidity shortfall disappeared on its own. Yet, the IRS found that the employer had remedied the shortfall, and that by making the ongoing quarterly contributions (which did not include the old, expired, liquidity shortfall contributions) the employer had taken reasonable steps to remedy the shortfall.

Another example is PLR 9737032 (also waiving the 4971 excise tax) in which the employer failed to make a $3 million liquidity shortfall contribution due on April 15, 1995, because it would have imposed a financial hardship on the business. However, on June 30, 1995, the employer merged the plan with another plan that had more assets compared to its annual payments. By merging the plan with another plan, the employer "eliminated" the liquidity shortfall, and the IRS waived the excise tax, despite the fact that the liquidity shortfall

[1] Because of the technical definition of "liquid", it is quite possible that the Plan may be able to sell some or all of the assets that are not included in the definition of "liquid."

contribution was never made. The IRS held that, "the merger… constitutes a reasonable step to remedy the liquidity shortfall…"

In Rev. Rul. 95-31, the IRS issued guidance on the liquidity shortfall contribution (among other things) and included a list of "consequences" if an employer fails to satisfy the liquidity requirement. The consequences include the interest charge to the end of the quarter (which was charged to the funding standard account), the excise tax, and the fact that the plan is prohibited from making certain types of payments. However, the carryover of the contribution requirement is not listed (because it is not one of the consequences, as there is no carryover).

An Error in the Proposed Regulation

The preamble to the proposed regulation suggests that the proposed change in the administration of the liquidity shortfall contribution was due to a statutory change. However, other than changing the section number from 412 to 430, the statutory language is the same. From discussions with individuals involved in the drafting of the proposed regulation, we understand that the statutory change was in § 4971 which has a new "ordering rule" for crediting contributions back to the first quarter for which there is an unpaid payment.

However, this new ordering rule does not change the liquidity shortfall rules, for two reasons.

- First, because the ordering rule applies to the excise taxes in § 4971(a) and (b) (unpaid contributions for a plan year), but not to the liquidity shortfall excise tax in § 4971(f) (for an unpaid installment for a quarter).

- Second, because § 430(j)(4)(C) provides that the liquidity shortfall contribution is considered unpaid until the close of the quarter in which it *arises*, and *not* until the quarter in which it is *paid*.

Accumulating and Pyramiding Contributions are Too Harsh and Not Intended

As explained above, the incentives and punishments of the extra interest charge, the 10% excise tax, the 100% excise tax, the prohibition on lump sums, the notification to the PBGC, and the PBGC lien, are certainly sufficient to encourage compliance without adding an additional punitive pyramiding contribution requirement.

However, with the exception of the rather minor interest charge, all of the intended consequences listed above come with some flexibility. The excise taxes can be waived, and the PBGC can forego enforcement of the lien. This flexible regime is appropriate and intended. The liquidity shortfall is a rather imprecise tool for measuring true liquidity needs – the fact that it often disappears on its own, without additional contributions, demonstrates the reason that there should be some flexibility in its enforcement. The two PLRs discussed above also show why flexibility is important. Often, the liquidity shortfall appears and disappears with little warning. The measurement occurs every quarter, and action is required with 15 days. It is not unusual for

a plan sponsor to be unaware of a liquidity shortfall until several months after the fact. If there were no flexibility permitted, it would be simply too harsh.

Because of the way the liquidity shortfall is constructed, it can also be the case that the shortfall can be *impossible* to determine within the time to correct it. For example, it is often the case that an employer simply does not know the plan's AFTAP until well after April 15. In fact, PPA specifically contemplates that the AFTAP may not be known until September, for a calendar year plan. In this case, when the AFTAP is determined, an employer may learn *for the first time* that a liquidity shortfall occurred the prior March 31. Because the accumulating and pyramiding requirement has no flexibility whatsoever, it produces a needlessly harsh result in such a case.

For these reasons, the drafters of the original liquidity shortfall requirement wisely built in the mechanisms for flexibility, and that flexibility was carried over into the Pension Protection Act.

The lien, which can be enforced or not, and the excise taxes (10% and 100%) which can be waived in cases of reasonable cause, provide a balance of incentives, disincentives and flexibility, that works well for the pension system. Adding an inflexible accumulating and pyramiding contribution requirement would upset this balance, and would be contrary to the statute.

For the reasons explained above, we respectfully request that the proposed regulation be modified before it is finalized, to reflect the fact that the liquidity shortfall contribution does not accumulate and pyramid.

Sincerely,

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