BNA, INC.
PENSION & BENEFITS

DAILY

Reproduced with permission from Pension & Benefits Daily, 3 PBD, 01/05/2011. Copyright © 2011 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

# Liquidity Shortfall—An Important Problem in an Obscure Rule

BY DAVID R. GODOFSKY

ERISA practitioners are familiar with the concept of a band-aid on top of a band-aid. The liquidity shortfall contribution is a prime example. The comment letter below explains an error, hopefully to be corrected, in the proposed pension funding regulations (REG-108508-08) relating to the liquidity shortfall contribution (71 PBD, 4/14/08; 35 BPR 833, 4/15/08). This brief explanation may be helpful in understanding the rule itself.

Ordinarily, the normal funding rules make it extremely unlikely that a pension plan could actually run out of cash to pay benefits, as long as the employer is making the required contributions. This is because a retiree at age 65 will collect benefits over 20 to 25 years, while funding shortfalls are generally required to be made up with contributions over seven years. Even under the worst of circumstances, a poorly funded plan will receive more in contributions than it pays out in benefits, or at least enough that, with prior existing assets, there is plenty to pay current benefits.

*David R. Godofsky (David.Godofsky@alston.com) is a partner of Alston & Bird, LLP, Washington, D.C., leader of its Employee Benefits and Executive Compensation Practice Group, and a Fellow of the Society of Actuaries.*

However, in order to ensure benefit payments, tax code Section 430(j) (previously Section 412) contains a liquidity shortfall contribution requirement. The liquidity shortfall is supposed to be measured at the end of every quarter, and if there is a shortfall, a contribution must be made within 15 days to make it up. However, there are numerous problems with the liquidity shortfall contribution.

One problem is the guy looking out the back window, giving directions. Section 430(j) measures liquidity needs by looking at the 12 months of prior payments (with an adjustment for lump sums, explained below) and multiplying that by three to get three years' worth of payments. However, the past 12 months may not be a good predictor of the next 36 months. Another problem is that it requires a contribution, but there are often other ways of solving a liquidity shortfall. To understand these problems, a simple example of the liquidity shortfall calculation may help.

**Example - Plan A**

On March 31 Plan A has:

- *Assets*: $20 million (including $7 million of partnership interests);
- *''Liquid'' Assets*: $13 million;
- *Liabilities*: $40 million; and
- *Trailing 12 month payments*: $8 million (including $4 million of lump sums in one quarter, April 1—June 30 of the prior year, and $1 million in annuity payments each quarter).

To determine Plan A's future liquidity needs, you look out the rear window. Because the Plan is 50 per-

cent funded, you only count 50 percent of the lump sums. (If it were 100 percent funded, you would ignore the lump sums.) So, the trailing 12 payments, after the adjustment, is $6 million (all of the annuity payments and half of the lump sums). Multiply this by 3, and you get a liquidity requirement of $18 million.

No matter how easy it is to sell the partnership interests, they are not considered ''liquid'' for this purpose. So, your liquidity requirement ($18 million) is compared with the liquid assets ($13 million) to produce a required contribution of $5 million. If not made within 15 days, by April 15, there is a 10 percent excise tax ($500,000) and the plan must stop paying lump sums.

However, the liquidity shortfall will disappear on its own by June 30. The plan will pay out $1 million in annuity benefits, reducing its ''liquid'' assets to $12 million. The trailing 12 benefit payments on June 30 will be only $4 million, because the quarter with $4 million in lump sums drops out of the average. So, the liquidity need is $4 million times three, or $12 million—the same as the liquid assets. No more shortfall!

The shortfall can also be remedied by selling some of the partnership interests and investing that money in publicly traded stocks and bonds, and mutual funds.

Interestingly, because a surge of lump sums often creates the liquidity shortfall, and because the shortfall requires the plan to stop paying lump sums, it can be the case that there will be a liquidity shortfall *every other quarter*. That is, the plan will shift back and forth between having a shortfall and not having a shortfall.

Before the issuance of the new proposed funding regulations, it was clear that the $500,000 excise tax could be waived (if the shortfall were due to a reasonable cause), and the $5 million contribution requirement would disappear on June 30. However, the proposed regulation states that the $5 million contribution requirement persists, even if the shortfall has disappeared. As explained in the comment letter, the authors have concluded that the proposed regulation is in error on this point.

One final note —Company A did not have its actuarial valuation yet on April 15, so it did not actually know that it was only 50 percent funded. Consequently, on April 15, when the liquidity shortfall contribution was due, Company A did not actually know how much contribution was required! In fact, had it known before March 31, it would have sold some partnership interests, and there would not have been a liquidity shortfall at all.

The following letter, written by myself, and signed by six other actuaries, is being submitted to the Internal Revenue Service Jan. 5. The letter concerns the proposed regulation relating to liquidity shortfall contribution (REG-108508-08).

## Comment Letter Sent to IRS

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 three 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 percent 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 five consecutive quarters, the excise tax increases to 100 percent.

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


COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC.
ISSN

and a new liquidity shortfall due July 15 of $2 million. By Sept. 30, the liquid assets will be $9 million and the liquidity shortfall contribution due Oct. 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 Oct. 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 percent to 100 percent. 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 percent and 100 percent 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 contribution was never made. The IRS held that, ''the merger . . . constitutes a reasonable step to remedy the liquidity shortfall. . .''

In Revenue Ruling 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); and
- 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 percent excise tax, the 100 percent 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 forgo 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, dem-

[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.''

onstrates 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 percent and 100 percent), 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.

Signed by: Susan L. Breen-Held, consulting actuary, of the Principal Financial Group; Thomas J. Finnegan, principal, of the Savitz Organization; Douglas K. German, chief actuary, of Retirement Buck Consultants; David R. Godofsky, partner, of Alston & Bird, LLP; Ellen Kleinstuber, managing consultant, of the Savitz Organization; Maria M. Sarli, U.S. retirement resource actuary, of Towers Watson; and James E. Turpin, president, of the Turpin Consulting Group.


COPYRIGHT © 2011 BY THE BUREAU OF NATIONAL AFFAIRS, INC.
ISSN