



[Home](#) - [fs](#) > [Web](#) > [Asppa.org](#) > [Public_html](#) > [Archive](#) > [Gac](#) > 2005 >
Comments on Proposed Regulations for Distributions from a Pension Plan under
a Phased Retirement Program

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Department of the Treasury
Internal Revenue Service

26 CFR Part 1
[REG-114726-04]
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ASPPA appreciates this opportunity to comment on the proposed regulations regarding Distributions from a Pension Plan under a Phased Retirement Program (REG-114726-04) (the "Proposed Regulations" or the "Proposal"). ASPPA's comments are set forth in two separate documents. This document addresses all of ASPPA's comments on the Proposed Regulations except those relating to the selection of a normal retirement age. A separate document addresses the proposed rules regarding normal retirement age.

ASPPA is a national society of retirement plan professionals. ASPPA's mission is to educate pension professionals and to preserve and enhance the private pension system. Its membership consists of more than 5,500 actuaries, plan administrators, attorneys, CPAs and other retirement plan experts who design, implement and maintain qualified retirement plans, especially for small to mid-size employers.

ASPPA commends the IRS and Treasury for their efforts to provide rules to allow pension distributions during the "phased" retirement of plan participants. The complexity and inflexibility of defined benefit plans is an oft-cited reason for their lack of appeal to many plan sponsors. These efforts to recognize special employment arrangements for older employees are a step in the right direction to preserve the defined benefit plan as a viable retirement plan option for employers. As described in this letter, ASPPA has a number of suggestions that we believe will make these proposed rules more effective and easier to apply.

Summary of Key Issues

I. Eligibility Issues

A. Phased retirement programs should be permitted for *all* employees; select key employees should not be barred from participation.

B. Eligibility for phased retirement should be based on either (1) a 20% reduction in hours, (2) a 20% reduction in total pay, or (3) a 20% reduction in base pay with a demonstrable reduction in hours or responsibility.

C. Once it has been determined that there has been a bona fide phased retirement, subsequent monitoring and adjustments of benefits should not be required.

D. Phased retirement should not be prohibited prior to age 59½. Rather, it should be permitted at a time when distributions are otherwise permitted under the plan.

E. Phased retirement should be treated as separation from service for purposes of the 10% additional tax on premature distributions under IRC §72(t).

Discussion

It is good long-term social policy to allow access to funds based on a flexible definition of retirement. Nowadays, "retirement" does not necessarily involve a complete cessation of work. Many times, employees shorten their work schedules as a precursor to complete retirement. However, many employees are prevented from doing so unless some portion of their retirement benefits are made available during the phased retirement.

Employers and employees should have the flexibility to agree on personalized employment arrangements. Retirement arrangements are taken into account by both the employer and employee in coming to agreement on salary, hours, and other benefits. In developing rules and policies governing pension plans, the Treasury and the Service should provide guidance that facilitates an efficient employment marketplace, provides options that are appealing to both employers and employees, and avoids policies or rules that unnecessarily complicate and influence the employment relationship. Overly restrictive or inflexible rules can lessen the interest and benefit of pension plans to employers and employees alike.

The preamble to the Proposed Regulations indicates that a number of the proposed restrictions for phased retirement arrangements arise from a concern that an employee will outlive his or her retirement income or have a level of retirement income that is too low. However, the reality is that workers and employers commonly strive together for creative solutions that permit employees to continue working in some fashion while obtaining access to needed retirement benefits. At a certain point in an employee's career, the employee may consider retiring from his or her long-term employer to start pension benefits, while obtaining employment with an unrelated employer. If the employer wishes to retain the services of a retirement-eligible employee, the employee's desire to receive pension benefits puts the employer at a competitive disadvantage compared to the new employer. In certain situations, this may put pressure on some employers to consider new work relationships. For example, employees may find employment through an outside employer that "leases" the employee back to the original employer. Others may "retire" only to be retained as an independent contractor or be rehired by the original employer. In some cases, it may not be clear under existing law whether the new relationship occurred after a bona fide retirement, calling into question the permissibility of a pension distribution. The phased retirement rules present an excellent opportunity for alleviating these uncertainties. To this end, ASPPA recommends that the Proposed Regulations be made more flexible in a number of areas.

- **Eligibility Issues**
- Phased Retirement Should Be Available to Key Employees

The Proposed Regulations would prohibit a phased retirement arrangement for certain key employees, *i.e.*, one of the top-ten paid employees owning the largest interests in the employer, and any owner of more than 5% of the company. This *per se* exclusion is unwarranted, unfair, and would unnecessarily discourage the use of phased retirement programs by small employers.

There are no existing *per se* limitations on benefits or plan features for key employees. The proposed restriction in this area seems particularly harsh where the actual benefit values are not increased on account of phased retirement, so that the only issue is one of timing. In such a circumstance, the key employee is being financially penalized for not taking his or her benefit immediately, which can be done only if the employee fully retires.

There is no need to create such an extreme limitation on benefits payable to these employees upon a phased retirement. In fact, the Proposal's limitation would severely limit the usefulness of these rules for small employers, especially in the context of a change in leadership. Often, when a small company transitions to new owners or business leaders, the new leadership team views continued input from prior leaders as crucial to the successful continuation of the business. Allowing a business to offer phased retirement to key employees may encourage such employees to continue in a reduced role without having to completely forego pension payments. Under existing rules, these employees need to completely sever the employment relationship to obtain pension payments. Although the employer could retain the retired key employee's service on an independent contractor status, this raises the question as to whether the common law employment relationship has truly severed.

Outside the context of a change of leadership, a small employer might decide not to offer phased retirement to any employees if the company's decision-makers cannot take advantage of such a program.

ASPPA recommends that the Regulations be modified to eliminate the key employee exclusion and permit a plan sponsor to include all employees as part of its phased retirement program.

- Eligibility for Phased Retirement Should Be Based on Reduction in Hours or Reduction in Compensation

The Proposal would require an employee to reduce his or her hours of service for the employer by at least 20% to be eligible for phased retirement. This test is too rigid and fails to recognize other significant changes in the employment relationship under which phased retirement would be appropriate. Also, the hours test may be difficult to administer for employees paid on a salaried basis and for whom hours worked are not regularly tracked by the employer. ASPPA recommends adding a 20% compensation test as an appropriate alternative measurement to evidence a phased retirement of employees whose employment status has changed.

The hours test fails to accommodate situations in which an employee experiences a significant reduction in job responsibility yet still continues to work a "full-time" schedule. For example, an executive who supervises a substantial number of employees and is responsible for a particular department may desire to step down from this responsibility but continue to work a full-time schedule providing assistance to the employer in the same or different department with reduced oversight responsibilities. Such a fundamental change in the employment relationship and expectations can be just as real a "phased retirement" as a 20% reduction in hours, and would typically be evidenced by a significant reduction in pay.

ASPPA recommends that an employee's eligibility for phased retirement be conditioned on *any one* of the following (1) a 20% reduction in hours, (2) a 20% reduction in total pay, or (3) a 20% reduction in base pay with a demonstrable reduction in hours or responsibility.

- After an Employee Becomes Eligible for Phased Retirement, Only Limited Monitoring Should Be Required

Under current law, an employee who retires and commences a full pension benefit in accordance with the employer's existing plan terms can be later rehired and continue to receive the full pension benefits. The plan *may* provide for a suspension of benefits in that situation, but is not required to do so. ASPPA believes similar rules should apply in a phased retirement program. That is, if there is sufficient evidence that phased retirement was bona fide, a later modification of the employment relationship that results in an increase in hours or compensation should not require a reduction or cessation in the phased retirement benefit. Pension accruals during this employment may increase in recognition of the additional service or pay.

ASPPA recommends that an employee's eligibility for phased retirement be conditioned on a bona fide reduction in hours or reduction in pay that meets the employer's phased retirement program requirements. As a safe harbor, a bona fide phased retirement for this purpose should be deemed to occur where the reduction in pay or hours meets the employer's program standards for at least a six-month period. However, this safe harbor should not preclude the establishment of other facts and circumstances that indicate that the initial phased retirement was bona fide. Any subsequent increases in pay or hours should not require an adjustment to the level of phased retirement benefits, although the employer's program may contain provisions that require such an adjustment. The approach discussed in the Proposed Regulations could be retained as an illustration of what is permitted but not mandated.

- Phased Retirement Should Be Permitted at the Time Distributions Are Otherwise Available Under the Plan

The Proposal would limit the availability of phased retirement to employees who have attained age 59½. This limit was based on two considerations: (1) Treasury does not have the authority to permit payments to begin from a 401(k) plan prior

to severance from employment or attainment of age 59½ (except for hardship), and (2) for all plans, annuity distributions made prior to age 59½ may be subject to the 10% additional tax under Code §72(t) if the participant has not separated from service.

Age 59½ is not young enough to make a phased retirement program attractive. The 401(k) plan distribution limits should have little or no bearing on phased retirement rules for pension plans. Finally, the possible application of the 10% tax under Code §72(t) should not act to limit the availability of a phased retirement distribution.

An employer may wish to make a phased retirement program more attractive to employees by making it available at the plan's earliest distribution eligibility date. Many plans provide early retirement ages and subsidies that begin at age 55 (and some begin even earlier). Such a subsidy provides incentive to employees to completely retire from the employer at the earliest retirement eligibility date. Other plans permit distributions at anytime following a vested termination. Even if a plan does not provide a subsidy for an early distribution, the employee might desire to look for new employment in order to obtain a pension distribution, or, it may be beneficial to the employee to begin pension payments to help provide additional income in connection with a reduction in work. *One of the goals of phased retirement should be to allow an employer to implement a program that reduces the pension distribution restrictions and penalties so that employees will be encouraged to continue employment with the employer under changed conditions rather than find other employment.*

Employers should be able to offer an attractive alternative to full retirement that will allow employees to continue to work in a reduced capacity without giving up access to early retirement subsidies and other pension benefits that are available under the plan to fully terminated employees. At age 59½, much of the early retirement subsidy in many plans has already been eroded. Employers should be given latitude to determine at what age phased retirement is appropriate given their employment needs and policies and the underlying benefits and costs of their plans. Employers currently have this latitude in establishing early retirement subsidies and in setting the earliest time at which pension payments will be available to terminated vested employees. Employers should have this same latitude in establishing a phased retirement program.

The phased retirement rules are of particular interest to plan sponsors of, and participants in, defined benefit and other pension plans. Under current law, profit sharing and 401(k) plans are permitted to allow various in-service distribution options; we suspect the Proposal will not be particularly useful for these types of plans. Furthermore, since the distribution restrictions for 401(k) plans are not relevant to when distributions may be made from pension plans on termination of employment or retirement, such restrictions should not drive the phased retirement rules for other types of plans.

Finally, even if the Code §72(t) tax will apply to pre-age 59½ annuity distributions under a phased retirement program, participants should retain the ability to elect to receive distributions under the phased program, provided they are informed of the tax implications. There are no absolute restrictions on distributions because of the additional premature distribution tax. Implicit in the policy behind the additional tax is the employee's understanding of the financial impact of the tax and his or her choice as to whether or not to take a distribution.

ASPPA recommends that employers be given the flexibility to permit phased retirement as early as the earliest time under the plan when a fully terminated employee may receive or begin receiving plan distributions.

- Phased Retirement Benefit Should be Treated as Paid on Account of Separation From Service for Purposes of Code §72(t)

The 10% additional tax of Code §72(t) applies to annuity distributions prior to age 59½ except where the employee has separated from service. Because the phased retirement rules would permit retirement benefit distributions only because of a fundamental change in the terms of employment, the final Regulation should provide that, for purposes of Code §72(t), phased retirement benefits are considered to be paid on account of a separation from service. Thus, annuity distributions attributable to phased retirement should be exempt from the 10% additional tax under Code §72(t) as a series of substantially equal

periodic payments made for life [Code §72(t)(2)(A)(iv)].

ASPPA recommends that, for purposes of Code §72(t)(3)(B), the Service treat phased retirement distributions as being made on account of separation from service. In addition, the rules should clarify that phased retirement distributions will not be subject to the additional tax solely because an annuity payment stream goes up or down in accordance with a phased retirement program.

- **Phased Retirement Payments**
- Full Distribution Should Be Permitted Upon Phased Retirement

Under the Proposal, the level of benefits paid during phased retirement would be based on the level of the employee's work reduction. Such a rule would be burdensome and fact-intensive and would make the phased retirement option too difficult to implement, communicate, and maintain. ASPPA recommends that these rules be simplified to permit full payment of benefits (or any lesser amount) during phased retirement.

A pension plan must be designed primarily to provide benefits after retirement. Consistent with this principle, the phased retirement rules should recognize that phased retirement is simply a form of retirement, like early or normal retirement, albeit a form of retirement that exists in the workplace but is not affirmatively recognized under pension regulations. As such, there is no reason why the amount of distribution during phased retirement must be limited to a pro-rata portion of the full retirement benefit.

While an employer offering phased retirement may want to limit the benefit payments to a pro-rata portion, it should not be required to do so. In some cases, the employer might want to permit full distribution and still retain the services of the employee. Under current rules, this can be accomplished by a "retirement" followed by a rehire. As mentioned earlier, however, such situations may call into question the permissibility of a pension distribution if the prior retirement was not bona fide. The liberalization of the Proposal in this area would be a means to limit the inappropriate level of influence the current rules can have over the terms of the employment relationship in some situations.

ASPPA recommends that the rules permit full retirement distribution upon a phased retirement. Alternatively, if unrestricted full distribution is not permitted under the final rules, **ASPPA recommends** that if an employee's hours are reduced to no more than 500 hours per year or his or her compensation is reduced to less than 25% of the level of pay in effect immediately prior to the phased retirement, then the employer's phased retirement program may permit full distribution of retirement benefits to the retiree.

- Distribution Amounts Should Not Be Required To Be Adjusted For Subsequent Increase in Hours

Under the Proposal, the level of benefits paid during phased retirement would be based on the level of the employee's work reduction. Annual testing would be required to determine if the work-level has changed. Where the work level increases by a "material" amount (generally, a one-third increase or work at 90% or more of a full-time schedule), the employer would be required to reduce the phased retirement benefit payments.

The annual testing requirement is unnecessarily burdensome and would make phased retirement an undesirable option for most employers. As noted above, ASPPA recommends that full distribution be permitted upon phased retirement. Also, following an initial showing of a bona fide phased retirement, ASPPA recommends that any subsequent increases in pay or hours not require an adjustment to the level of phased retirement benefits (but such an adjustment should be an option that an employer may adopt). A partially retired participant should not be required to be treated any differently from a fully retired participant upon a subsequent change in employment status.

ASPPA recommends that no adjustment to the amount of phased retirement payments be required due to a change in work level following the initial phased retirement.

- **Impact of Phased Retirement on Regular Retirement Benefit**
- Benefit Accrual During Phased Retirement Should Not Be Required To

Be Pro-Rated

The Proposal would require plans to provide additional accruals during phased retirement. These accruals would be determined as if the participant had remained a full-time employee, except that the years of service credited for the phased retirement period is multiplied by an adjustment ratio based on the actual hours worked over the full-time work schedule (alternatively, the adjustment ratio can be based on the reduction in compensation during phased retirement). This rule could result in smaller or larger accruals for employees in phased retirement than for existing part-time employees covered by the plan (e.g., where the plan generally provides a full year of service for each year in which an employee completes 1,000 hours of service, or where a plan provides no credit for years in which an employee performs less than 1,000 hours of service). This inequitable result should not be required.

ASPPA recommends that the phased retirement rules provide employers with the option of treating phased retirees like other part-time employees in determining service for benefit accrual purposes.

- Reduced Accruals During Phased Retirement Do Not Violate Code §411(b)(1)(H)

Although the preamble indicates that the Proposed Regulations do not address any potential age discrimination issues, the final regulations should make clear that the requirements of Code §411(b)(1)(H) are *not* violated due to the possible reduction in accrual rate in accordance with the phased retirement rules. The Treasury has regulatory authority for such a position, with possible review from the Department of Labor (DOL) and the Equal Employment Opportunity Commission (EEOC).

ASPPA recommends that Treasury specifically indicate that reduced accruals during phased retirement will not violate the requirements of Code §411(b)(1)(H), and that Treasury request review by the DOL and EEOC on this position if it deems necessary.

- Offset For Early Retirement Subsidy Should Be Optional

The Proposal specifically requests input on how early retirement subsidies during phased retirement should be treated for purposes of determining the remaining benefit due the employee at full retirement. Employers should be given the option of determining the remaining value of the net benefit at full retirement with or without application of the early retirement subsidy paid during phased retirement. This would be fair in either case to employees if they are properly informed of the offset implications prior to electing phased retirement. If the early retirement subsidy is offset against the remaining benefit at full retirement, it should be valued by using the plan's standard actuarial factors or the actuarial assumptions provided under Code §417(e), as optionally specified in the plan.

ASPPA recommends that employers be permitted to design their phased retirement program to provide that the value of any early retirement subsidy paid during phased retirement is, or is not, taken into account in determining the net benefit available at full retirement.

- Clarify Offset Rules Where Phased Retirement Benefits Are Reduced During Phased Retirement

The Proposal appears to provide a special offset rule where phased retirement benefits are reduced on account of an increase in the work of the participant. See Prop. Treas. Reg. §1.401(a)-3(d)(3)(ii). This section is unclear and should be clarified.

ASPPA recommends that the final rules more clearly indicate how prior phased retirement benefits that have been reduced because of an increase in work are offset against the net benefit available at full retirement. A general statement that the total accrued benefit at full retirement is offset by the benefit that is actuarially equivalent to the value of previous payments (with or without early retirement subsidies as discussed above) should accomplish this goal.

- **Nondiscrimination Issues**
- The Availability of a Phased Retirement Program Should Not Be Subject

to Nondiscrimination Testing under Regulation Section 1.401(a)(4)-4

The Proposed Regulations indicate that the availability of a pension distribution during phased retirement would be a plan feature subject to the "benefit, right or feature" test under the Code §401(a)(4) regulations. Phased retirement distributions should be exempt from the Code §401(a)(4) requirements, provided that the plan permits distributions on the same terms to all employees who retire under the employer's phased retirement program.

The employer should be permitted to offer or deny phased retirement for any business-related reason, subject only to existing employment laws, and any applicable contracts, that apply to the employment relationship. Employers should be free to select the employees who are offered continued employment at reduced hours. The preamble to the Proposed Regulations reflects comments that phased retirement arrangements should be optional on the part of the employer and voluntary on the part of the employee. The employer's plan will merely provide enhanced distribution options based on that reality.

In this context, ASPPA believes it is appropriate to exempt the availability of phased retirement distributions from the Code §401(a)(4) tests. To require testing would invariably interfere with the employment relationship in a fundamental fashion. The focus should be on whether distribution is permitted when there is a fundamental change in the employment relationship. The only limitations on this ought to come from existing employment law, not from pension law. ASPPA recognizes, however, that if the pension plan applies specific conditions on phased retirement distributions, under which some employees in phased retirement will be eligible for distributions and some will not, then some Code §401(a)(4) testing may be appropriate.

ASPPA recommends that the final rules clarify that it is the phased retirement program offered under a plan that is subject to Regulation Section 1.401(a)(4)-4 testing. The actual selection of which employees are offered a phased retirement employment structure is an employment issue and is not subject to nondiscrimination testing under Code §401(a)(4). The final rules should provide that a plan's phased retirement program would automatically satisfy the nondiscrimination rules if the program were available on the same terms to all employees who enter into a phased retirement relationship under the employer's program. A plan that limits which phased retirees will be entitled to phased retirement benefits would be subject to nondiscrimination testing. The final rules should provide that for a plan which limits which phased retirees may elect phased retirement benefits under the plan, the relevant nondiscrimination test is whether the limitation discriminates significantly in favor of HCEs.

- Ignore Age and Service Conditions for Benefit, Right, and Feature Testing

The Proposal requests input on circumstances under which the age and service conditions for a phased retirement program should be disregarded in performing the BRF tests. Currently, age and service conditions, if not time limited, are ignored in applying the current availability test. These same rules should be applied to phased retirement. Also, because employers may be interested in trying phased retirement under these new rules for a trial period, time-limited age and service conditions should also be disregarded for a period of several years after an employer first implements its phased retirement program. This will give employers the opportunity to gain experience with phased retirement before committing to a longer-term program. After this transition period, the normal age and service rules would apply for any necessary BRF testing.

ASPPA recommends that age and service conditions required for distribution under a plan's phased retirement provisions be disregarded for purposes of the BRF tests provided the conditions are not limited by time. **ASPPA recommends** that time-limited age and service conditions be disregarded for a period of five years following the employer's initial implementation of phased retirement under its pension plan.

- HCE Status Should Not Remain Fixed After Beginning Phased Retirement

The Proposed Regulations would require that an employee who is a highly compensated employee (HCE) immediately prior to phased retirement must at all

times thereafter be treated as an HCE. This is inappropriate. Why should there be a difference between an HCE who reduces hours (and pay) and takes distributions through a phased retirement plan provision, and an HCE who reduces hours (and pay) but does not begin to draw down benefits from the plan (the latter may become an NHCE, the former must always be an HCE under the Proposal). Such a rule would add unnecessary complexity and could cause a plan to inadvertently violate nondiscrimination rules when there has been no change in the applicable benefit formulas.

ASPPA recommends that employees in phased retirement be treated in the same manner as other employees in determining status as an HCE.

- **Miscellaneous**
- Provide That Suspension of Benefits Notice Can Be Provided Upon Phased Retirement

The preamble to the Proposed Regulations requests input regarding post-normal retirement age accrual issues such as the application of the suspension of benefits rules. Currently, many plans distribute a suspension of benefits notice at the time an active employee attains normal retirement age. These notices are very difficult for employees to understand and often cause confusion and misunderstanding. However, the notices appear to be required by law to avoid having to perform complicated actuarial adjustment calculations for post-NRA service.

The existing suspension of benefits notice rules should be waived for employees who continue in employment after normal retirement age and have never commenced receipt of their benefit. This issue is distinct from the phased retirement rules and would likely require action by the Department of Labor as well as Treasury. Assuming the existing suspension of benefits rules are not changed, the notice requirement should be deemed to be satisfied where notice is provided at the time phased retirement begins, with no need to provide additional notice at normal retirement age.

ASPPA recommends that the final rules provide that if the suspension of benefits notice is provided to an employee at the time phased retirement begins, then no further notice will be required at normal retirement age or at any other time.

- Permit Retroactive Annuity Starting Date For Phased Retirement

The final rules regarding a plan's ability to permit distributions with a retroactive annuity starting date provide that the retroactive date may not precede the earliest date at which the participant could have otherwise started receiving benefits from the plan. The retroactive annuity starting date rules should be coordinated with the phased retirement rules to permit retroactive phased retirement to the earliest date the participant satisfied the conditions for a distribution under the employer's phased retirement program.

ASPPA recommends that the final phased retirement rules clarify that phased retirement can be used in conjunction with the retroactive annuity starting rules, thus permitting an employer to offer a retroactive annuity starting date as of the earliest date at which an employee satisfies the conditions for a phased retirement distribution.

- Apply Nondecreasing Annuity Exception to Code §417(e)(3) Requirement to Separate Portions of Phased Retirement Payments

The Service has recently emphasized that the determination of whether or not the applicable interest and mortality rates apply is based on the totality of the optional form paid to a plan participant. Thus, for example, if a participant's benefit is distributed partially in a lump sum and partially in an annuity, the Code §417(e)(3) rate would need to be used in determining both the value of the lump sum and the optional annuity form. In the case of phased retirement, discrete elements of the participant's benefit will be paid at different times. The suitability of a particular conversion rate for any portion of the benefit should not be based on the form of a prior – or future—payment.

ASPPA recommends that the final rules specifically provide that optional forms factors applicable to each discrete segment of a participant's benefit be

determined as if that discrete segment were the only benefit payable under the plan.

- Clarify Whether Phased Retirement Should Be Available to Partially Vested Participants

The Proposed Regulations do not indicate whether a plan would be permitted to offer phased retirement to participants who are not fully vested. Plan sponsors should be provided with the flexibility to implement a phased retirement program that is available to partially vested participants (but should not be required to include partially vested participants). As a practical matter, it is likely that few employers would extend phased retirement to participants who were not fully vested because the benefit value for partially vested participants is likely to be very small. However, employers should be given this latitude should they decide there is value to provide this option to employees.

ASPPA recommends that the final rules be clarified to indicate that an employer can offer phased retirement to participants who are partially vested, but that the employer is not precluded from limiting phased retirement to participants who are fully vested.

These comments were prepared by the Phased Retirement Task Force of ASPPA's Government Affairs Committee, chaired by Marjorie R. Martin, MSPA, and primarily authored by Mark L. Lofgren, Esq., APM. Please contact us if you have any comments or question regarding the matters discussed above. Thank you for your consideration of these comments.

Sincerely,

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