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IRS ACTUARIAL GUIDELINES HANDBOOK

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- o Are the newly imposed guidelines actuarially sound?
- o Is the IRS properly equipped to administer the guidelines?
- o What are the professional implications of not complying with the guidelines?
- o How have differences been resolved?

MR. LARRY D. ZIMPLEMAN: We are fortunate in having on the panel two actuaries who have had some experience in using and analyzing the Actuarial Guidelines Handbook. Mr. Dick Solomon is with Alexander & Alexander in Los Angeles. Dick has over 10 years of consulting experience, primarily with larger plan sponsors. Mr. Art Anderson has his own practice in Needham, Massachusetts. Art also has over 10 years of consulting experience and has done quite a bit of work in analyzing the Actuarial Guidelines Handbook.

I'd like to begin this morning's discussion with a brief history and overview. Dick will then follow that with a discussion of his observations based on some practical experience with the guidelines. Art will follow that with his discussion on some of the theoretical or conceptual aspects of the guidelines.

Needless to say, the Actuarial Guidelines Handbook is one of the more controversial developments in the last few years. The guidelines were announced in late 1984 -- the worksheets were released in November along with a set of instructions that were given to IRS Employee Plan Specialists to use upon audit

of qualified defined benefit pension plans. If any of you have not had an opportunity to look at the instructions that accompany the worksheets, they are a very good source of summary information on maximum deductible limits under Section 404, minimum funding requirements under Section 412 and other pertinent Revenue Rulings and Revenue Procedures that come into play.

The Audit Guidelines Handbook is the IRS's attempt to give field agents the tools they need to review the funding issues and actuarial issues involved in qualified defined benefit plans. Up to the time when the Handbook was issued, the field agents were poorly equipped to deal with the issues associated with the funding of these plans. The Handbook uses three ways to try to deal with these actuarial issues:

1. Five worksheets which ask distinct questions about some of the more important issues. Worksheet 1 deals with mechanical problems -- was the plan in effect by the end of the year? Were the contributions made within the allowable time? Does the Schedule B show a deficiency? Worksheet 2 asks questions about the acceptability of the funding method -- what funding method was used? Is the funding equation balanced? Are the assets valued appropriately? Worksheet 3 is the most controversial area for enrolled actuaries. It purports to test the reasonableness of the actuarial assumptions by computing gains and losses over the last five years and using that as a measure of reasonableness of the assumptions for the future. Worksheets 4 and 5 support Worksheet 3. Worksheet 4 attempts to quantify any deferred gains or losses as a result of unreasonable retirement ages or annuity purchase rate assumptions. Worksheet 5 is used only when the actuarial cost method is the individual aggregate method.

2. The Guidelines also attempt to assist the field agent in choosing questions that are most likely to reveal a problem. Examples of this would be whether there is more than a 2.5% difference between the interest assumption and the salary scale assumption. Another general guideline is to question any annuity purchase rate that is more than 110% of the annuity purchase rate based on a 5% interest rate and the UP 1984 Table. Another general guideline -- and one that is likely to be controversial -- is that

3 to 5 years is a reasonable time for testing the effect of the actuarial assumptions.

3. A telephone program that enables the field agent to discuss any special problems with an actuary in the IRS National Office. In the past, this has not been encouraged.

The IRS has been training its field agents since early 1985 in the use of these Guidelines. We should expect to see more plans being audited in the future where these worksheets differ from some of the standards used prior to this, for example:

1. The worksheets separate investment gains and losses from other gains and losses. Investment gains and losses are then related to the amount of plan assets rather than the accrued liability.

2. The worksheet incorporates the effect of deferred gains and losses from unreasonable retirement ages or annuity purchase rates. It imputes a gain or loss from these sources and adds it to the actuarial experience gains and losses to see if the assumptions are reasonable in the aggregate.

3. In the past the IRS was using a 2% reasonableness standard; it now says it changes that to a 4% reasonableness standard meaning that if the product of your assumptions is plus or minus 4%, you supposedly satisfy the guidelines.

Finally, it is important for all enrolled actuaries to remember that falling within the guidelines of the worksheets does not guarantee that the IRS will not challenge that actuarial assumptions. The IRS can challenge the assumptions regardless of the worksheet results.

MR. RICHARD H. SOLOMON: We're going to discuss a very serious subject today -- the IRS worksheet used to audit plans for purposes of determining the reasonableness of funding. I'll discuss my experiences with you and give suggestions as to what you might do in the event that you are challenged. I'd like to emphasize that this is a true story and is not a fable.

PANEL DISCUSSION

The name of this presentation is "An Actuary in Worksheet Land."

One of our clients sponsors a final average salary defined benefit plan. The plan is relatively non-controversial. The benefit formula is not integrated with Social Security, bases benefits upon five year final average salary, and uses the 4/40 vesting schedule.

One day I got a call from a gentleman who seemed to be either a game show host from a foreign country or possibly an Internal Revenue Service agent. The conversation would have been about as clear in either case. We'll call this individual Agent No. 1. He said the following, translated into plain English.

"Your weighted average percentage is a negative 46%! We only allow 4% -- you're in serious trouble!"

I asked what this meant, and he indicated, in so many words, that the Internal Revenue Service was now going to work on finding funding abuses.

He described a worksheet that could be used by any individual in the field to uncover these abuses. He suggested that we program this worksheet on our computers and test all of our clients every year since all of our competitors were thinking of doing this.

Agent No. 1 gave me a telephone number to call within the next 2 weeks to continue our discussions after reviewing the worksheets. I called this number to discuss this subject further with him, and the Internal Revenue Service agent answering the phone immediately let our a barrage of profanity, translated roughly to say "I've told him never to use this extension; don't you ever call him at this number."

I then got a call that Agent No. 2 was taking over the case for Agent No. 1. The Internal Revenue Service finally sent the worksheet for my review, and I discovered the following:

1. The worksheet does not take benefit changes into account -- thus producing spurious gains and losses.

2. The worksheet produces invalid results if the level of participation varies significantly.

I called Agent No. 2 to describe my discoveries, and he indicated that "It is impossible that this worksheet is incorrect since it came from headquarters."

I told Agent No. 2 that, in addition to the theoretical problems, the practical situation dictated against my client or myself intentionally setting up plan losses. First of all my client was a government contractor and was either partially or perhaps wholly reimbursed for the pension costs, so why I would set up plan losses and lowball the cost was somewhat beyond me. The second item is the client takes the maximum tax deduction every year -- if we were trying to lowball the cost, this would not make a lot of sense. So what we really have is a combination of a practical impediment to this reasoning, plus the theoretical problem. The third item is that the client was very responsible in terms of the accrued liabilities where benefit improvements had been made. There were sufficient assets to cover the accrued liabilities, and again it just didn't hang together that we were purposely lowballing the costs.

Agent No. 3 was then assigned. I indicated that this wasn't going to be the IRS's strongest case and asked to be spared my time and my client's expense. Agent No. 3 said.

> "Don't worry about your client's expenses, this is just part of his obligation in conducting business. If he gives you any trouble on your fees -- let us know!"

I then hit upon an idea.

The first thing that I did was recalculate the worksheet (this is going to be one of the suggestions that I am going to make to you) -- recalculate the key worksheet items, in my case using consistent benefit levels, to correct for any theoretical problems in the worksheet. The normal cost percentages that the IRS was looking at to develop and generate these losses were 2.21, 2.79, 2.91% in the last three years. This is primarily due to very significant benefit improvements during the course of the review. Had we had the same benefit

level and approach in effect, using the current benefit level, they would have varied from 2.91 to 3.12%. The results were that the losses were decreased dramatically. For one year, the loss that the IRS was showing as $736,000 was reduced to $114,000. I also requested permission from the IRS to recalculate the cost to adjust for significant changes in participating payroll. The client was a very successful company with a short eligibility requirement for the retirement plan. During the last three years of this review, it went from 328 to 481 participants. It just was not the same group. The funding method used throughout was the Frozen Initial Liability Funding Method.

By now Agent No. 4 had been assigned. I asked Agent No. 4 if I could send her another worksheet revised to reflect at least the benefit changes and she said, "Yes." She seemed to see some validity in my arguments and indicated that she would discuss this situation with one of the senior actuaries in Washington. Some time later she called and indicated that the procedure would be that the Los Angeles office would disallow the new evidence that I was submitting. I would then appeal to Washington, and that office would then probably rule in my favor.

Agent No. 4 apparently was ultimately able to convince the IRS of the validity of our position. The Internal Revenue Service then sent us a letter indicating the following:

> "It's OK for now, but we'll be watching this case in the future."

In summary, I wish I could say that I've learned something from my experience with the IRS worksheet, but unfortunately I cannot do that. There are enormous theoretical problems, and it would seem only sensible for the Internal Revenue Service to withdraw the worksheet before it does more damage.

I do have the following recommendations:

1. Recalculate gains and losses after adjusting for the effects of theoretical defects in the worksheet.

2. Review "Common Sense" factors with the agent.

MR. ARTHUR W. ANDERSON: I've inherited the title of being some kind of a guru on Worksheet 3 even though I never had any actual experience with it. I think in New England we are just not infested with the same kind of agents they have on the West Coast. The reason I got involved with Worksheet 3 was that two years ago when it first came out, I was asked to join a panel discussion at the 1985 Enrolled Actuaries Meeting to discuss Worksheet 3 and any possible corrections or technical flaws that I might find in it. It was the first time I had seen it, and the first time anyone had seen it. I began to look at it and as I did so, after about a day or two, it began to dawn on me that the problems of this worksheet were not simple -- small items like whether you should add the asset gains with the liability gains or whether you should adjust for plan changes or other things. Undoubtedly, you should. The problem with the worksheet was that it was totally based on falsehood and, in fact, it represents the converse of our Society's motto. It substitutes impressions for demonstrations and opinions for facts.

First of all I ought to say something about which many of you, and I too, have forgotten. Years ago we all took an exam in statistical inference, and we learned how to perform various tests of significance and hypothesis testing and so forth. Many of us have forgotten some of the basics of that. Nevertheless, we do remember that there are some powerful techniques there, so if you back away and take a look at the whole picture -- Worksheet 3 is an attempt at a hypothesis test for reasonableness. It is an attempt to have a mechanical sampling of experience and from this sampling of experience to infer either that the assumptions are reasonable or that they are not reasonable.

I first concentrated on the asset side of the IRS's worksheet. This is the very first example I tried. You can pick you own and try the same thing, and I encourage you do so because it is very instructive. It will bring back a lot of Part 2, and it will also strengthen you when you come up against problems with Worksheet 3 because you will realize that the whole thing is completely fallacious and it has no prayer of standing up against any kind of determined assault. It is falsehood founded upon falsehood.

I decided to just hypothesize a pension fund and invest it all in common stocks and then create a very simple statistical model of the stock market. I took

rates of increase in the S & P Stock Index for a ten year period and computed from that the mean of the supposed increase in the S & P Stock Index. It appears to be 7.23% for this period.

This is all contained in my obscure paper, little read because it appeared in the *Pension Journal* which was later renamed the *Pension Forum*. The paper appears in Volume 1, Number 1. It is a paper that I wrote mainly because people asked me to show that the astonishing results I have obtained actually have some foundation.

I also discovered that if you estimate the standard deviation of the S & P 500 Stock Index on the basis of the ten years that I picked, which happened to be the most recent ten years available, the standard deviation was eighteen and a fraction points. So I hypothesized that the stock market was a black box in which you invest, for which the mean rate of return is 7% and the standard deviation is eighteen percentage points. I then computed the probability that, if you had used as your plan assumption the mean rate of return from the underlining distribution of my hypothetical model, Worksheet 3 would reject you, i.e., you would be one of those unfortunates who obtains the ratio that is off 4% or more. The way I computed it, that probability is about 70%. In other words, if you have a fund invested in common stocks, I estimated you have a 70% chance of losing the test of Worksheet 3 regardless of the size of your fund. If you want the details of that calculation, you can read my paper.

If we step back from normal distributions, means, standard deviations, etc., and think about reality, you will understand why this is so. It is so because the corridor on the assets is four percentage points regardless of the variability of the rates of return in the series itself. If the IRS had said it will allow you two standard deviations on either side of the mean, that would be one thing. But it didn't, it just set this corridor at four percentage points. Why didn't it have a larger corridor about the mean? Well here is why -- in order to do that, it would have to allow you plus or minus 21 percentage points.

Another way the IRS could fix Worksheet 3 is to take a period larger than five years, in other words take a larger sample from the distribution. As you know,

if you take a larger sample from a distribution, your estimate of the mean will be more reliable. However, in order to obtain a 5% confidence level for this hypothesis test, the IRS would have to enlarge the averaging period from 5 years to 81 years.

This result has since been disputed. Someone told me that I assumed that the mean of the sample was distributed normally. Because the size of the sample was only three years, I should have assumed a Student's T distribution. I don't know how many of you ever got that far in Part 2, but I figured that if I ever mentioned Student's T distribution at an Enrolled Actuaries meeting I would lose 99% of the audience as well as myself. Anyway, it is true that the Student's T distribution is more appropriate. If you use that, you get 60 years, which is close enough for government work, because whether it is 60 or 81 years, don't forget that the underlying assumptions in this example are that the S & P 500 Stock Index has a stationary mean, that it has a stationary standard deviation, that the plan stays invested in it the entire time, and that you don't change your assumptions. So it wouldn't be a very practical test for the IRS to use.

Before going to the liability side, I want to point out that there is not a solution for this problem. I cannot think of any possible inference that you can draw from a five year average of investment gains that will tell you anything about the underlying mean rate of return of assets on a pension fund. I've already proven that if you knew in advance what the actual rate of return was going to be, the test would reject you 70% of the time. But you are not clairvoyant, so you are not going to be right on the mean and nobody expects you to be. If you're off the mean, you are probably going to get rejected 80% or 90% of the time. This isn't because the IRS didn't design the worksheet right, it's because there's only so much you can infer from a stochastic process with a limited sample size. This is distressing to the IRS because it wants to infer something. It is not taking the scientific attitude that you and I are supposed to take. It seems to have decided in advance what kind of answer it wants. As a matter of fact, I have been reminded by Ira Cohen at the most recent Enrolled Actuaries meeting that Revenue Ruling 63-11 established a principle that 5 year average gains and losses will measure the reasonableness

of the assumptions in the plan, so this is nothing new. I agree that it will measure the reasonableness, but it will measure it very, very coarsely.

Now I would like to turn my attention to the liability gains and what the IRS does with those. It separates asset gains from liability gains which is a step forward. Years ago, in 1963, one of the Boston agents would compute five year average gains and losses as a percentage of the normal cost; everyone lost under that one. Again, I constructed an arbitrary model to see what your chances were of surviving this test even if you've done something entirely reasonable. I hypothesized a very simple valuation where your pre-retirement assumption was a flat 7% a year decrement due to mortality or whatever cause. No ancillary benefits were included in the valuation. Under the same kind of statistical analysis, I assumed that we have 1,000 employees, each of them subject to a 7% probability of leaving the group during the year. As you go on from there and do some analysis using binominal distributions, you could find out that, if you have a thousand life plan under these circumstances, the test will work very well. In fact the IRS could have a much smaller corridor than 4% and still have it perform at a much better confidence level than 5% confidence. However, if you would drop the number of participants to 10 from a thousand, then 39% of the time you are going to blow the test under my hypothetical plan. If you drop the number of participants to five, then you're going to blow the test 54% of the time. All of this is by way of reviewing what is written down in my paper, so I will refer you to it, if you like detail.

Now we are getting to the crux of the matter. For the same set of assumptions, we have a hypothesis test which will declare the assumptions reasonable almost 100% of the time if you have 1,000 lives, but it will declare them unreasonable 54% of the time if you have only 5 lives. Therefore, this hypothesis test is obviously fallacious because it depends on the number of lives you have rather than on anything intrinsic in the assumptions or experience.

Those of you who have dealt with the IRS for a long time will realize that this result was probably intentional. The IRS would have to allow a huge corridor, much greater than 4%, for the small plan. For the single person plan, I think the corridor is plus or minus 100%. I haven't actually tested it, but it

doesn't make any difference because with one participant you are not dealing with a stochastic process anyway. The IRS would have to allow a very tiny corridor for the large plan, yet it doesn't care about the large plan because it is after the doctors, let's face it. The professional corporation plans have been developed to a high art on the West Coast and only to a modest art on the East Coast.

This brings up a question as to how this all got started. I think the actuarial profession does bear some of the blame for this. There are some pretty outrageous stories about assumptions for one man plans assuming retirement at 55 with a wife 20 years younger, even though he wasn't currently married. If you were familiar with these matters, you might say, "So what?" Let the guy fund whatever he wants because either he'll hit the Full Funding Limitation or, when he goes to draw his benefits, he'll be limited by Section 415. If limited by Section 415, there will be a lot of excess assets which will revert. When they revert, the government can tax them. Whether the guy takes his deductions this year or next year or front loads them or back loads them should be all of a piece.

However, the problem is that the government doesn't use Generally Accepted Accounting Principles. It uses the "Cookie Jar" approach to budgeting. This is something many people don't understand, given all the controversy about budget deficits. If I go out and buy one of the ships we have in our harbor in San Diego, I would spend one hundred million dollars. I believe the government expenses the the entire hundred million. It views that as money spent. Maybe because it takes five years to build it, the government actually spreads it over five years. However, it doesn't set up an account and amortize the ship over its 40 year lifetime. The government treats expenditures on roads, ships, bridges, and so forth the same way it would treat expenditures on Social Security, food stamps, and other things that are consumed immediately. Therefore, whether the government is actually in deficit or not is arguable because nobody has the facts, but that is beside the point. The point is that the government does not want to go on Generally Accepted Accounting Principles and therefore, based on their "Cookie Jar" approach to budgeting, the money you deduct this year for your pension expense is money lost. It doesn't care if it is going to get the money back in five years. The government doesn't want it

in five years, it wants it now. If the government doesn't have it now, then as far as it is concerned, it is never going to get it. That is its horizon, I'm not kidding. I've actually heard those words from a prominent spokesman.

Now I would like to say something about reasonableness. What is reasonableness, anyway? Taking a scientific approach, the assumption would have to be reasonable if you turned out to be right. So if you said the average rate of investment return was going to be 7%, and 25 years later you actually computed it and it turned out to be true, then that would be a prima facie case that that assumption was reasonable. It would definitely imply that the assumption was reasonable. However, it would not imply that it was unreasonable if you came up with a different rate of return at the end of 25 years; you might have guessed the right mean of the distribution but just had a bad run during the 20 years. In other words, there is still variance even over a 20 year period. It is possible the true mean rate of return on stocks is 7%, but over a particular 20 year period, you got 8%. I haven't done the numbers, but I think that is well within two standard deviations.

I do not think that reasonableness in the scientific sense is what the IRS has in mind. To it I think reasonableness means any assumption which produces an answer that the IRS has predetermined. I think it is very happy that the wide net that Worksheet 3 casts will pick up 75% of the fish because it allows the IRS a great deal of discretion on the part of the individual who is handling the case. The IRS likes to have that discretion because it feels that while it can't really define reasonableness scientifically it knows it when it sees it. And so if the IRS casts a net wide enough and picks up all the plans, it can sort out the General Motors and the big corporation by and large, except for those like agent No. 3, who hadn't got the word that he is supposed to let the big plans go. The IRS wants to get the doctors; it wants to get the professional corporations that you guys invented out here. It hated them then, and it hates them now. The IRS wants to have discretion to give these people a hard time. It likes especially to pick on people who are all alone. This is why it is the duty of all of us to shout out as loud as we can that the emperor has no clothes. This worksheet is crazy. It has not a shred of validity to it. It does not measure reasonableness. It will not stand any kind of scrutiny. I'm certain it will lose in court, if and when it gets to court, and

I think it will because I've had some inquiries on my paper from some higher placed attorneys wanting to know about the T distribution.

The fact is that the worksheet doesn't have anything to do with reasonableness at all. It's something that somebody dreamed up without reviewing his textbook on Part 2, and without standing back and thinking about how he might test for reasonableness, and how much you can infer from a five year average of anything, and whether there is anything to be inferred. For example, I'm not entirely sure that there is a stable mean in the case of investments. In fact, over the last 15 years we have seen evidence of a rather unstable mean rate of return on investments, whether it is the stock market or bond market or whatever.

I am not sure there is anything we can infer statistically about the stock market from any kind of test. In fact, as far as I know, anyone who has such a test isn't going to be here because he's going to be too rich. I don't believe there is any kind of test that can infer the true mean or even the movement of the mean or the true standard deviation of the stock market. If you can't infer that from your test, then you can't infer anything about the reasonableness of anybody's assumption about that.

Finally, on future rates of return, reinvestment of assets which haven't even come in yet, I don't think there is any scientifically justifiable way of saying that any particular assumption is wrong, except maybe a negative rate of return. If somebody assumes a 2% rate of return after retirement for a person now age 35 and the IRS came to me and said that was totally unreasonable, 2% is not a prevailing interest rate, my answer would be, "But there was a time when it was. It was a long time and during that time my assumed rate of return was correct. Therefore you may not agree that my assumption is reasonable; however, there is not any way to prove that it is not reasonable." In fact, 2% is just as reasonable as assuming 11% or some higher rate we all thought was going to last forever but in the last few months has evaporated.

We have a fundamental problem between actuaries and the IRS here, and in fact we have an adversarial relationship. The IRS is not interested in joining with you in a search for truth. It is not interested in a committee of the Society

or someone appointed to help improve Worksheet 3. By now everybody realizes there isn't any way to improve Worksheet 3. You can make cosmetic improvements in it, but it will still be fundamentally false. There will never be anything you can infer about reasonableness from a small sample like this. You would have to do something extraordinary. I guess this means for the moment your best bet is to face facts right off the bat when you are confronted with Worksheet 3 and you are informed that you have the 46% corridor problem like Mr. Solomon's. In the East, the limited experiences that I've heard about with Worksheet 3 have shown that the agents tend to be cowed by the actuary's own knowledge. So, I think the better you know this worksheet and the better you know how stupid it is and why, the more likely you are to scare off the agent. The details that I have heard from the East are that the agent, once he hears the actuary talking knowledgeably, gets scared and runs for the hills because he can find something else in somebody else's return to hit. You should realize that you are in an adversarial proceeding and not try to pretend anything else. Treat is as an adversarial proceeding. If I were you and I was advising a client, I would simply tell the IRS that I am not only going to maintain that my assumptions are reasonable, but that I am going to prove in court that the whole worksheet is crazy. It's a crock. It's wrong. It not only is wrong in my situation but it's wrong in every situation.

I will end my speech by saying I had a talk with a prominent IRS spokesman on this matter. He said, "I have no doubt your analysis is correct. And I have no doubt that, if pressed, we would lose in court. But then we will simply get legislation passed because we want the money." And that is the end of it.

MR. JAMES F. A. BIGGS: For those of us who have more than ten years of service in this business, this is obviously nothing new. I can recall a situation about 20 years ago with a triangular telephone conversation with one of the actuaries in the IRS national office on one corner, a San Francisco reviewing agent on a second corner, and myself on the third, with the actuary and me in total agreement, but the reviewing agent saying "No! I'm going to disallow." Lee Parks and I were involved in a situation at the Pentagon a number of years ago where ultimately the government representative leaned-back, fixed us with a half-serious glare, and said, "Gentlemen, you simply fail to recognize that you are dealing with your sovereign."

Stopping IRS bashing for the moment, in this session and in sessions yesterday, references to professional corporation plans in California brought forth knowing chuckles and snickers and I think we all know why. There is a problem, I think a legitimate problem, in that it is sometimes hard to distinguish when one man's concern for adverse deviation gets mixed in with what most charitably might be called actuarial prostitution. How do you solve this problem? Who is going to set the standards? Are we going to take a position that says I can demonstrate through statistical techniques that you can't find out for eighty-three years whether my results are reasonable and therefore go away. I don't think that's a practical, real world answer to the problem. Should the actuarial profession, should IASB, be attempting to establish standards of reasonableness in this area? What do we do?

MR. ANDERSON: That's a very good question, I've asked myself that a lot. I think if we were dealing in abstract, I would say that it should be each actuary's own judgment. I really think there ought to be a standard, set not by fiat, but with the agreement of actuaries in general. We have to be sympathetic to the problems of the IRS in this area. In the case of professional corporations and one man plans, we really ought to settle on some limits, especially on such things as post-retirement assumptions and the retirement age assumption. We should recognize that we are not just dealing with an abstract desire to predict future experience, but also we are doing something that affects the revenue of our government. So, actually I am not totally unsympathetic to their plight. I think the actuarial profession has been very reluctant to establish hard standards, and I think this is an area where we should. The standard should be different depending on the size of the plan, because for a very large plan you would actually have some way of measuring or maybe even doing a study of what people's retirement ages were. On a one man plan, statistically there isn't any way of proving which assumption is better than another and therefore we have to just set some standards. If we had done so a long time ago, we probably would be better off today. This business is very troublesome to me. I was amused when I first talked, but I'm not amused any more because I think the legislation referred to will come about because of the fact that the worksheet has no validity and eventually the IRS will try to nail somebody who wants to fight. When it does that, it will lose. Then we'll see crazy legislation about actuarial assumptions that will apply across the

board and be back in the soup. I would rather see that we move in the direction of standards, especially in small plans. Don't forget, you could pick one set of assumptions for every one man plan in the country and be reasonable. I think you can ask any actuary to pick a set of assumptions for a particular plan that covers one person, and those assumptions could not be shown to be unreasonable. It would be better to have us do it, rather than to have legislation do it.

MR. ELI GREENBLUM: This legislation, which will provide the eventual solution that the IRS will be satisfied with and that the IRS will be able to use to implement its policies, will probably consist of a fixed assumption for investment return which will change every year, and the IRS will issue it on December 15 for all plans in the following year. I don't think that's anything anybody here wants to live with. I am wondering whether it's a farce, the matter of setting standards. Has there been any contact between the various actuarial bodies such as ASPA, the Academy and the Society that would be affected by it, or is this just something that is discussed at sessions like this? Does anybody here know what we are doing in that area?

MR. ANDERSON: I'm not aware of anything, but that doesn't mean it isn't happening.

MR. ZIMPLEMAN: My experience as far as the Academy goes is that it has expressed its concerns about the worksheet in an official way. It has gone on record with what it sees as the technical flaws. I think as far as the Academy is concerned, it is trying very hard to do something along the lines you described. It ultimately comes back to what Art said, that the IRS wants the money now. It is very difficult because we do all know there is some small percentage of plans out there where the test of reasonableness is very difficult to ascertain, and the IRS keeps citing those situations and using them over and over again. We're not helping ourselves because of those situations.

MR. STANLEY B. ROSSMAN: I'd like to take a guess that there's something less than 10,000 pension actuaries in the United States, and I think the IRS is concerned about regulating us. I would guess that there are over 100,000 insurance agents in the United States, and the IRS is not concerned about

regulating them, because there are no standards; there never have been as to what kind of policies can be sold for pension plans and whether the premiums can or cannot be deductible. Whatever you pay into an insurance policy, a fully insured plan, is automatically deductible. Forget actuarial worksheets or guidelines, forget the reserve standards which are being set by the in-house actuaries of an insurance company; the IRS is just totally ignoring all of those supposedly lost revenues. One of the things I would like to see is that, if the IRS is going to impose standards, it should do it all across the board and not just pick on the consulting actuaries who are trying to save a client a little money as opposed to being in an insurance product with outdated guarantees.

MR. RICK A. ROEDER: As much as anyone else in here, I am very concerned about the IRS guidelines. But I feel compelled to say this, I think those guidelines are only here because the actuarial community, and I include myself, has been much too lax in letting terrible work slip through the cracks, and not taking the time to anonymously send something to Les Shapiro in an egregious case. I would like to share some of my personal experiences. I had been one of those people who let cases slide through the cracks for a number of years. About two years ago, I got so infuriated in one takeover case that I did send something to Les. I'm not at liberty to discuss what happened after that. I'm not saying that across the board this is always the right thing to do. Sometimes it may be correct to talk with the other actuary involved first to find out what's going on. I think we have just created this mess ourselves, largely by letting inconsistencies in the interest rate and salary scale assumption, which logically should have a consistent rate of inflation. I think most of us in this room have seen work that's really sub-par and not taken any action. So I think that's why we are where we are today.

MR. CHARLES BARRY H. WATSON: I think that it's undoubtedly clear that many of us here are wishing to express our apologies for what we have done in the past in this area. I think, though, that we perhaps are beating ourselves too vigorously in some regards. After all, there is a real question if we are talking about the choice of assumptions, the reasonableness of assumptions, etc., whether what has been done in most cases, is really that egregiously wrong as we perhaps are thinking. The problem is that there are some of these

plan situations that are viewed, correctly or not, as situations where there should be tighter requirements put on them because of the possibilities for the plan sponsors to exercise unwarranted discretion. It isn't necessarily that our assumptions are wrong, it's that, perhaps, the entire structure is incorrect. I've talked to a number of people who are really concerned about this. They incidentally think it is far more than a small number of plans. They have the feeling that any plan which has a small number of employees has been set up just to provide a personal medium for the owner or the few owners to swindle the government of some money. I think it may be that the solution lies in tighter restrictions put on that type of plan. But of course this is in itself difficult. What sort of controls can you put on small plans that will not inevitably seep over into large ones? What I'm really trying to say, though, is that I'm not sure that one can deal with this, to try to define actuarial standards of practice or even principles which would handle the matter. It may be as Rick Roeder said a minute ago, that there are some cases where even the professional conduct of people is called into question. And in that case, we can deal with it, and perhaps we should deal with it in that fashion.

On a different point, I would also like to comment on what the previous speaker, Mr. Rossman, said about insurance company contracts. There again we're looking at a question of perception. The people in general, and the IRS in particular, think that if you pay a premium to an insurance company, whether it's a good, bad, or indifferent premium, at least you lost the money, and that will serve you right.

MR. WILLIAM D. MAGARO: I think this area we've been discussing is of particular importance given the proposed tax provisions that would levy a 30% tax on any excess accumulation due to unreasonable assumptions. Now, if that passes and the IRS uses the guidelines to determine that excess, we have a real problem. It's not just a matter of "Hey, at this point, client, you may have a disallowance of some part of your tax deductions." This means the client is going to have some interest to pay and maybe some back taxes. Now we're talking about a nondeductible 30% excise tax. What I would like for you to address is if you have had any discussions with the IRS relating to that 30% tax and whether or not the guidelines as you understand them would be the standard that would be used to determine that excess.

MR. ANDERSON: Two or three nights ago, there was a program on PBS which showed the inside story of the development of the new tax reform act in the House. It was so revolting to me. The very idea of trying to engage in rational dialogue with people like that is so ludicrous. You saw how decisions were getting made. They were never getting made on the basis of what was right or best for the public. They were always done on the basis of pressure. We actuaries are the worst in that regard because we are brought up to live in a different world -- in a world of civilized discourse and a world of rational consideration. Over the 25 years that I've been involved in the pension business, I have seen the Society grow to over 10,000 members. We constitute a pretty big group of people, but we so seldom get together and scream. We don't deal in terms these clowns understand. I think all the position papers and papers like mine are thrown instantly into the wastebasket, and we're not even on the same playing field. Even though some of the people we talk to at the IRS are actuaries, they have been co-opted by that system. This tax legislation is really a circus. I don't know whether to laugh or cry. I'd rather think, at the rate they're going, it will never pass because it will never get done.

MR. ZIMPLEMAN: I believe that the penalty tax provision has been struck.

MR. ANDERSON: No. Only against actuaries. There's still one left against employers.

MR. MAGARO: There were two. The one against the actuary has been struck, but not the 30% penalty on the disallowance. That really puts it in a whole different light.

MR. SOLOMON: I think we shouldn't discount the Machiavellian factor here. A lot of us have talked about the actuarial profession bringing this on. I think Art's comment is a good one to put things in perspective. There is a certain amount of political sex appeal in being able to soak the rich. At the same time, if you are in the IRS, there is also a certain amount of political sex appeal in being able to put together a worksheet that purportedly brings in additional revenue. If there was one case that the IRS could find, you know that it would bring these people in front of some Senate committee and represent this to be the standards of the profession, even if there is only one

case. So it isn't so much a matter of us not doing our job, that's just the political reality as Art was saying.

One other comment, I'm from California and we've heard these comments about the professional corporation and the 35 year old doctor retiring at 55 with a 35 year old spouse. I think that started in the East, because with the assumptions we use in California he would retire with 2 wives who were 35 years old.

MR. SCOTT C. SUSTMAN: I guess I've been one of the fortunate, or unfortunate, few to actually go through an exercise with the IRS on this whole question. It was last fall and one of the things I tried to do, and was successful in doing, was postpone the inquisition with the reviewing agent until I had a chance to go to the Society presentation about the actuarial guidelines. One of the things I'd like to bring out in this forum is that in dealing with the reviewing agent, he was well aware of the fact that three weeks of "intensive training" does not make him an actuary. Now maybe I was fortunate in having someone who was actually rational and an IRS agent at the same time, and this may be an isolated incident. I found that through talking to him knowledgeably about the worksheet as well as utilizing the opportunity on that worksheet for identifying extraordinary gains or losses, in the large plan that I was handling, where we were not within the guidelines when first calculating it, it turned out to be an appropriate situation at the end. Again, small plans are going to be a problem. I do not see any real easy solution to it. My only comment is if you do get called before the IRS you shouldn't stomp your feet and say you are going to see the IRS in court. That's going to put the IRS in an awkward position as well. I found that if I worked with the IRS, we could generally work something out.

MR. JOHN C. MUEHL: I'm curious about how many people here have had one of their plans audited by the IRS. (Editors Note: about 1/3) My experiences were similar to Mr. Solomon's in that the agent was in fantasy land, and it was hard getting him back to reality. But, it put the fear of God into me, and I have been checking all of my plans to see what potential problems are out there. How many people have been checking their plans to see if they do meet the guidelines? Looks like the same people. Of those people who have checked -- How many of you have had all of your plans pass the guidelines? (Editors

Note: no hands raised) The IRS says that the guidelines are set so that 95% of the plans will pass.

MR. TRACY L. FILLIGER: I would like to see if anybody has any feedback regarding a plan that I had signed to as an Enrolled Actuary. The IRS called the plan administrator and questioned the assumptions, and said it felt they were unreasonable. The person who answered had told the IRS that I was no longer with that company. The IRS said that's fine and that the current actuary could sign to the assumptions that the IRS was promulgating as being reasonable. So, I would like to ask the question to what extent do we as actuaries gainsay each other's work and will go on record as stating 6% is reasonable even though another actuary is willing to sign at 7% -- to what extent are we going to get each other into hot water by implying that each other's actions are unreasonable?

MR. ANDERSON: I think it is important to realize that if you have a statistical series, such as rates of return, there are a lot of sophisticated tests which can be used to determine whether the mean of that distribution is in a certain range or not, or whether both 6% and 7% are correct in the sense that whatever the mean is, both numbers are within two standard deviations of it. This is one of the things that most puzzles most people, the peculiar conclusions that can be drawn about stochastic processes as opposed to totally predictable things. One of the conclusions that you often can draw about a stochastic process is that both answers, or 5 answers, or 10 answers, as long as they are within a certain range, are correct. There is no way to distinguish which is more correct than the other one. I have the feeling you wouldn't have to gainsay anyone even if you changed the assumption. You might simply say that they are both in the range of reasonableness. Intuitively, we know there is a range of reasonableness. In fact, statistically there is a range of reasonableness, in the sense that, if you analyze the statistical nature of what it is you are trying to predict, you can show that if you don't know what the mean is; you merely estimate it. There may be many estimates which fall within the reasonable range.