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THE INTERNAL REVENUE SERVICE ACTUARIAL GUIDELINES HANDBOOK--THE REST OF THE STORY

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Recorder:	NORMAN S. LOSK

- o Concerns of the IRS
  - --Why was the handbook developed?
  - --How will it be used?
- o Concerns of the actuarial profession
  - --How will it affect the actuary as a professional?
  - --How will it affect the actuary as a practitioner?

MR. NORMAN S. LOSK: Almost one year ago, an announcement was made to the effect that the IRS would be publishing new audit guidelines to be used in the audit process involving defined benefit pension plans. In November 1984, the associated worksheets were published, and in December, the text of the guidelines (the instructions) on completion of the worksheets was made public. It's probably fair to say that the actuarial world has not welcomed this particular set of material with "open arms."

In sorting out our feelings and concerns about the audit guidelines, it is important to understand them fully. This means understanding the environment in which they were developed and the purposes they are to serve, as well as their technical content and import.

There is no question that the IRS is responsible for regulating the funding of the retirement programs under Sections 404 and 412 of the IRS Code. From that standpoint, there are reasons for the development and use of these audit guidelines. Today, we are going to hear from Mr. John E. Wade who will give us the perspective of the IRS relative to the need for these audit guidelines, how they were developed, and generally how they will impact the audit process.

There are some concerns within the actuarial profession relative to these audit guidelines. Some are technical in nature. Some have broader issues. To discuss his perspectives on some of those broader issues, we have Mr. Michael J. Tierney.

MR. JOHN E. WADE: What are the audit guidelines? What are they intended to be? They're a comprehensive set of instructions to the IRS field personnel who will be conducting audits of defined benefit plans. The audits are conducted by IRS agents in the district offices. These people are not actuaries, and we felt that they needed a detailed set of instructions to aid them in doing these audits. The guidelines are concerned with audits of funding issues; issues under Sections 412 and 404 of the Code, minimum and maximum funding, and the regulations under those Sections. The guidelines are intended to raise most of the major issues regarding funding during the audit process. The guidelines were developed by the actuaries in the national office. They are the ones who actually put the guidelines together and helped train the agents who will be using them.

The main reason the guidelines were developed is that the IRS has the authority and also the responsibility for seeing that Sections 412 and 404 of the Code are complied with. We feel that to do this, there has to be some enforcement of these Sections of the Code, and this requires a successful audit program. There is a second reason for actually putting together the guidelines in their current form. After all, the responsibility under the two Code Sections has always been there ever since Employee Retirement Income Security Act of 1974 (ERISA). It was called for in some committee reports to ERISA and in various old revenue rulings. If that authority has always been there, why were the guidelines put into print just last year? To answer that you have to look at what was done in the past. In the past, we did have an audit program. The program reviewed the actuarial assumptions that were being used, judged them for reasonableness, and looked at various issues regarding the funding methods and asset valuation methods. However, that program had some problems. The audits were not done by actuaries, and the agents doing the audits did not have the training they needed to adequately audit the plans, to discover the issues that needed to be discovered, or to judge what was being done when they reviewed an actuarial valuation on Schedule B. The agents also felt uncomfortable about their lack of knowledge. They did not feel they had the expertise to evaluate certain things the actuaries may have told them or to perhaps challenge an actuary if need be on his assumptions or funding method or any other issue.

Another problem with the existing audit program was that the agents had a heavy workload. They dealt with other things, not just audits, for example, determination letters. They did not have the time that was needed to investigate a plan in depth and to consider all the aspects of funding that needed to be considered. The second main reason for implementing the current program was to correct these weaknesses that existed in the past audit program.

The guidelines are intended to raise virtually every important issue regarding funding. Obviously we could not cover everything. There may be some other issues that need to be covered, and the instructions provide a little more information for the agents in actually conducting an audit. They might point out some common problems or some typical things to look for or a little better explanation of some of the questions on the worksheets.

There are three main worksheets and various supplementary sheets that may or may not be used. The worksheets are designed in a question format. This was done to make them as simple and straightforward as possible so that an agent (just by following these questions) would be able to look into most of the important funding issues. Let's look at the worksheets themselves and see what is actually there. The first one deals with some general questions that are fairly mechanical in nature. For example, were the contributions made within their required times for either minimum funding or for taking a deduction? Was proper approval received for changing the funding method? Was the required material attached to the Schedule B? Were the 415 limits reflected properly in the funding of the plan? Were the dollar limits projected improperly? Were the ten-year bases maintained properly as required under the 404 rules? There are many other issues. Those are just examples of a few of them.

The second worksheet deals with the reasonableness of the funding method and the asset valuation method. It goes through some questions and answers and provides the agents with some checks to see if the funding method and the asset valuation method are proper. For example, there are a series of questions that enable the agent to check the balance equation to see if that is being handled properly. A question regarding scheduled benefit increases is included. Are they handled in accordance with the regulations and with Revenue Ruling 77-2? Are salaries projected properly according to the regulations? On the asset valuation method side, there is a question about the corridor limit--is that handled properly?

The third worksheet is the one that has created the most controversy. Worksheet 3 deals with the reasonableness of the actuarial assumptions. There are some people who feel that we shouldn't be looking at this, that it should be left to the discretion of the actuary. We believe the choice of assumptions in the funding of a plan plays too important a role to be ignored. The cost can vary tremendously with the choice of assumptions, and without an audit of this, the audit program would not be complete.

When developing Worksheet 3, we judged the assumptions used to gauge what will happen in the future, by looking at past experience. The presumption was that past experience would be indicative of future experience unless there were some overriding reasons to believe otherwise. The second point is that the proper way to measure the experience in the past was through the use of gains and losses under the plan's funding method.

Next, it is necessary to look at the assumptions in the aggregate. For this reason, we couldn't isolate just one assumption, for example the interest rate, and provide a range or something along that line. We felt the proper way was to look at the overall effect of the assumptions, and the only way to do that was to look at the assumptions in the aggregate. Next, as far as judging the reasonableness of the assumptions, we would look for a consistent pattern of recurring gains and losses. If there was a pattern of substantial gains or losses, that would indicate the assumptions may not be reasonable and may need to be changed. We are also looking at a fairly recent period. We feel that if we go too far back into the past, the experience is not as reliable. Experience can change. The employer's work force can change. There are many other changes that can occur, so we feel that the last few years (just before the year under consideration) is the period to consider.

The next step was to decide, since we were going to be looking at gains and losses under the plan's funding method, what kind of tolerance level should be allowed. We don't anticipate that we'll be challenging most assumptions. We don't think we will have problems with mainstream actuarial practices, but only extremes of minimum funding and maximum deduction problems. The theoretical goal selected was that we would only be challenging assumptions where there was a 50 percent variation in cost. After some analysis and calculations, a test program, and reviewing some Schedule Bs, we came up with the 4 percent corridor in the guidelines. This was tested to confirm our earlier analysis.

Another aspect of Worksheet 3 is that we don't want to use hindsight. We were looking at the choice of assumptions based on the information available at the time they were chosen. We are not saying "Well, you chose your assumptions in year one and in years two and three that experience didn't occur, therefore, your assumptions were bad." We are looking at the experience immediately preceding the year the assumptions were actually chosen. Again, the worksheet is written in a fairly straightforward manner so that the nonactuaries can complete it as early as possible.

In regard to implementing the program, I want to comment on the selection and the training of the agents who will be doing the audits. It was recognized that we needed well-qualified agents who could develop some expertise in the area. We started by selecting the senior agents--the ones who already had the most experience in defined benefit plans and who already had completed quite a few audits. We knew they would need some additional training, so another training course was established. All of these people did have some training in the past from a basic training course they went through before they became involved with audits. The course discussed the basic actuarial funding methods. It gave them some instructions in those and also in some interest calculations and things of that nature. The agents selected for the audit program went through another intensive course designed to give them better instruction in the funding methods and some intensive training in the use of the worksheets.

The agents are now given more time on each audit. They're given fewer cases to audit. This gives them the time needed to go into depth on the audits. Also, all the agents are going to be spending a substantial amount of their time doing these audits and not other things. Probably in the neighborhood of 75 percent of their time will be spent doing the audits. We are also going to be providing them with some additional training. For example, during the coming year, we are going to start a two-step review process. The first will be a review of some of the cases that they have completed. The cases will be sent to

Washington, and the actuaries in Washington will review the work and discuss it with the agents. We might make comments such as, "Well, you should have looked at this or gone into this in a little more detail." The review is intended to provide them with some additional training. The second step involves some of the actuaries in Washington going out to the districts and actually working with the agents on the audits, perhaps on some of the more complicated cases. It is to provide them with some additional training and to also give us a better feel of exactly where they stand and what they're doing.

Another part of the audit program is increased telephone contact. In the past, if an agent had a question about any aspect of funding, to pick up the phone and call Washington was a formal and complicated process. They had to go through their supervisors and chain of command before asking a question. Now these agents can just pick up the phone and call us at any time with questions. This is considered an important part of the program.

Only the agents who have had the special training are allowed to use the worksheets. There are other agents who are doing audits as in the past, but they aren't supposed to be using the worksheets unless they have had the proper training. We want to make sure that people who are using the worksheets are well trained. I would suspect that there will be some additional training classes in the future.

If a plan you are working on is audited, and the agent goes through Worksheet 3 and says "You're outside the corridor, and it looks like your assumptions are unreasonable," you will have the opportunity to present any other information you might have. There is some flexibility built into the worksheets. There is one line where adjustments can be made for something called nonrecurring gains. Thus, gains or losses that are due to causes that aren't expected to recur in the future can be eliminated. You can present any evidence or arguments along those lines you might want to make.

There are other comments you might like to make. For example, with spread gain methods, the worksheets don't make any comments about new entrants. You may feel that you are outside the corridor because of the effects of the new entrants, not because of experience gains or losses. So, any other arguments you want to make can be presented at this time to the agent.

He may accept them and be in agreement, or he may have questions. He may be willing to call us in Washington on the telephone program, or he may just not agree with you. At this point, if the agent is still in doubt, he can send it back to Washington under the formal technical advice procedures. We would then review the material and make a decision. During this period (if it does go to Washington), you will have an opportunity to present your arguments in a conference with us. If the agent in looking at the case feels he can make a decision and that technical advice or contact with us in Washington is not needed, you still have the right to request technical advice from Washington. Then it would be sent to us to review to see if technical advice is warranted.

I want to make a point that the guidelines are just guidelines. There are perhaps times when we will want to look at the assumptions in a slightly different manner. In particular, there was one technical advice memorandum published about a year and a half ago. It dealt with a fairly specialized set of facts. It was a deduction issue with only one individual in the plan who was at the 415 dollar limit. The interest rate was very conservative; I think it was 5 percent. Because the individual was at the 415 dollar limit, there wasn't any possibility for a counter balancing loss through some other source. Even though the first year of the plan was being audited, the assumptions were challenged. So, that was one case where the assumptions were looked at, but not directly through the use of the guidelines.

In summary, considerable resources have been used in the audit program so far, in developing the program, writing the guidelines, training the people in the field, and in the ongoing implementation of the program. The program is considered important. Based on the audits that have been done so far, the program is considered a success. There are many more issues being raised on audits than were raised in the past. Some of them deal with the assumptions, but that appears to be a small number of cases. Because of the program's importance and the success so far, it is anticipated that it will be expanded in the future.

MR. MICHAEL J. TIERNEY: In the IRS Actuarial Guidelines Handbook, Chapter 400, Section 410, the first paragraph references the Internal Revenue Code, Section 412(C)(3) which provides that the plan's actuarial assumptions must be reasonable taking into account the experience of the plan and reasonable expectations. Paragraph 2 goes on to conclude that, "a measure of the reasonableness of the actuarial assumptions is the level of gains and losses produced." That statement is fair enough, but the IRS has chosen this to be <u>the</u> measure, not <u>a</u> measure. So what we have is a guide to measure the reasonableness of actuarial assumptions using the level of actuarial gains and losses.

Paragraph 5 from this chapter introduces the concept of potential gains and loses. It says, "Potential gains and losses resulting from these types of assumptions are deferred gains had losses and should be considered in the specialist's analysis of whether the plan has been experiencing substantial gains or losses from sources likely to recur." So not only do we have an IRS judgment of reasonableness based on what has happened but also a judgment by using potential gains and losses that haven't yet occurred. I admit to substantial disagreement with this approach. Make rules regarding prospective experience if you must, but don't justify them under the guide of gains and losses. The point is that an IRS judgment through evaluating experience is not necessarily restricted to past experience (even though the statement itself refers to the gains and losses <u>produced</u> as the measure).

We can't change the plan's <u>cost</u>. We are dabbling with the recognition of the incidence of <u>contributions</u>, but we can't change the cost. We're just talking about cost recognition on the time line.

The IRS has chosen to measure the reasonableness of actuarial assumptions by looking at the level of gains and losses. Do we as a profession agree with this method of determining reasonableness? If we don't, what should we do about it? We may not yet know the answers, but I hope we will be sensitized to some of the professional issues.

I would like to look at the American Academy of Actuaries guides, opinions, and recommendations as they are contained in the 1985 yearbook. First, consider the Guides to Professional Conduct, Item Number 3--Relations with Other Actuaries. Since the IRS has actuaries, the "other" referred to in the guides in this context means the actuaries from the IRS: "The member will conduct all professional activities on a high plane. The member will avoid unjustifiable or improper criticism of others and will not attempt to injure maliciously the professional reputation of any other actuary. While recognizing there is substantial room for honest differences of opinion...." I interpret those statements as emphasizing the need to provide substantial room for honest differences of opinion. This is part of what our profession is all about.

Guide 4--Actuarial Calculations and Communications, Part b, states that "any assumptions made are adequate and appropriate...the methods employed are consistent with sound actuarial principles and practices...." Guide 4 is general on purpose. The Academy did not forget to specify how assumptions should be made.

Next, it states in the Interpretive Opinions, Opinion No. 1, Part b --Disagreements and Differences of Opinion, "Because of the nature of actuarial work, differences of opinions among actuaries may arise particularly in choices of assumptions and methods.... If an actuary believes that material differences of findings have been engendered by incompetence or misconduct on the part of another actuary, the procedure set forth in the Bylaws...should be invoked." There is an interesting combination here. We allow differences of opinion, but if the differences can be shown to be a result of incompetence or misconduct, then those differences might be actionable.

Next, Interpretive Opinion 3c2--Advocacy states, "The actuary's professional judgment should not be subordinated to the judgment of others...," presumably other actuaries as well. Subsection 6 of that same Interpretive Opinion, Obligation Imposed By Law states, "Laws and regulations may establish restraints and obligations on the part of the actuary towards designated publics. The requirements of laws and regulations are binding; but when such requirements are in conflict with professional standards, they should be recognized as flowing directly from the laws and regulations and not from professional considerations." So it seems like, if a law or regulation is involved, we don't have to be professional. But if it's not, then we do. I'm not sure what the worksheets are, but I don't think they are law or regulation.

Last, Interpretive Opinion 4, Part c says, "An actuary who uses principles or practices which differ materially from any published Recommendation must be prepared to support the particular use of such principles or practices." Most of us are operating under the assumption that this opinion applies to us. I'm wondering whether the IRS actuaries read that when they did the worksheets?

Let's move on to the Recommendations. Recommendation 8-A, Paragraph 6.8 states, "The actuary may find it desirable to assume a conservative posture in selecting actuarial assumptions in conjunction with the Actuarial Cost Method employed, bearing in mind...the degree of uncertainty in assumptions and the potential for adverse fluctuation." So here we have as part of a Recommendation that perhaps we should be conservative, bearing in mind uncertainty and adverse fluctuation.

Here's the one I like best, Recommendation 8-A, Paragraph 6.3, "The actuarial assumption selected should reflect the actuary's best judgment of future events affecting the related actuarial present value. They should take into account the actual experience of the covered group to the extent information is available and applicable..., they should also reflect expected long term future trends rather than give undo weight to recent past experience." That summarizes what I consider to be a problem professionally with how we deal with the worksheets. We are expected as part of our Guides and Interpretive Opinions and Recommendations to use our best judgment, but also not to give undo weight to past experience, and yet the worksheets seem to demand that we do.

It seems like the worksheets might violate Recommendation 8-A, and Interpretive Opinion 4C seems to suggest that, upon request, the IRS's actuaries might have to support this differing practice. It doesn't seem to be covered by Interpretive Opinion 3C, Paragraph 6, since it's not a law or regulation. So here we have the issue of how one can measure the reasonableness of actuarial assumptions and how we, as a profession, should deal with someone else's measurement.

There are issues connected with the worksheets other than how one can judge reasonableness. We have the issue of what has been labeled the retroactive application of reasonableness. That is, we're measuring the reasonableness of assumptions as to future events against facts of the past. It would be nice to have a method of judging prospectively whether our prospective judgments are reasonable or not.

There are also other ramifications to the worksheets. As we've learned in the recent past, we are not immune to lawsuits. If the actuary is sued by a client for damages, will he be judged against the IRS guides of reasonableness. You can be sure that a litigating attorney will likely use them. The IRS is then brought into the suit. Can it be brought into the suit? If so, it would be from a different perspective, since it's not a tax issue but one of professional liability. Should we as actuaries take an official position now to protect our interests? I think that is an interesting question.

An actuary reminds me of a portrait painter. We both consider ourselves artists. We hate being told how to capture a likeness. We resent being told what are reasonable techniques. We abhor being judged in changing conditions out of context and by hindsight. So I say to all you artists, mind your brushes!

MR. MICHAEL JOHNS: Could one interpret recent experience like 12-13 percent interest combined with 5 percent salary increases as a non-recurring gain? One just would not reasonably predict that it would continue for a substantial period of time, even though it has been in effect that way for two or three years.

MR. WADE: You are looking at the assumptions in the aggregate, not just the interest and salary assumptions. You would have to recognize that the assumptions are long term in nature and would have to take that into account. I don't know that, if you are earning 13 percent interest or 15 percent interest currently, it necessarily means you'd have to assume it for all time. There is also the element of combining gains and losses from other sources with investment and salary gains and losses on the worksheets. The worksheets have the flexibility of adjusting for nonrecurring gains or losses. The interest rates are high now, but I don't know that they will always remain at this level. You may be able to justify some of the experience as nonrecurring, depending on all the facts and circumstances. Of course, short-term experience cannot be ignored.

MR. JOHNS: Suppose I'm assuming 7 percent interest and 5 percent salary increases with the expectation that, if interest rates run 10 or 11 percent, the salary increases will run 8 or 9 percent. But for the last two or three years, the salary increases have been running around 5 percent, and consequently, in many of the final average plans we are getting substantial interest gains but no offset in salary losses. So in the aggregate we see respectable actuarial gains, but we don't expect them to continue.

MR. WADE: You are getting into the specifics of that case as far as why there weren't offsetting salary losses. We would have to look at the specific facts of that case to see what is going on. Reasons for believing these salary losses might occur in the future or the gains would not occur in the future would have to be considered.

DR. ETHAN E. KRA: I object to it being described as a specific case because most of the people in this room as practitioners are finding that a significant number of plans over the past two to three years have had substantial economic gains assuming that the demographic assumptions have been right on target. We've had an anomalous economic environment for a few years, and we are afraid that IRS agents in the field are not going to recognize this. It's not one case or two cases, but it is endemic that plans are experiencing 15-20 percent investment yields during a period when salaries are going up about 6 percent. We've had assumptions that have been about 7 percent investment, 6 percent salary generating the gain, and after two or three years according to the agent, we are in violation. We are starting to see that in those few instances where there are specific audits going on, the agents are not understanding of this problem. They are blindly filling out the worksheets without knowing what they are doing other than what the rules say. They're objecting to things like 7 percent interest, 6 percent salary scale, which is well within industry practice and well within long-term reasonable expectations. The only way you get out of a problem in the current economic environment is to have a spread between salary and investment results of 5 or 6 points, something that never has happened as long-term historical experience.

MR. WADE: On these cases have you discussed these issues with the agents, pointed out what you think is anomaly--that it's just happening now and won't happen in the future? There is room on the guidelines for adjustment for things like that if it is just a short-term situation. Of course, adequate and persuasive arguments would have to be given for any adjustment to be made.

DR. KRA: But if it's an endemic situation throughout the United States economy, should the actuary be put on the defensive in every office around the country and in every one of our firms? Or should the field agents have better guidance from Washington that there is an anomalous situation, and if there are no gains, then there is something to worry about.

In today's environment, any IRS auditor doing an audit on a final payment plan and not finding consistent gains should be looking to find what's wrong with the assumptions, not challenging the gains.

MR. WADE: I don't think they're finding most of the plans outside the guidelines, so I don't know that I would agree with you.

MR. DONALD S. GRUBBS, JR.: I've had to face the problems of trying to determine what is the government's role in assuring that the plans will be appropriately and well funded and the problems in the development of minimum funding standards (which I worked for years to help bring about) because there were people losing benefits due to inadequately funded plans. On most cases, actuaries were acting responsibly. There have been some members of our profession who have acted irresponsibly.

I was the first director of the actuarial division of the IRS looking at those problems. After that, I was under contract with the Department of Labor to help them, prior to the reorganization, look at what criteria to use in determining whether assumptions are reasonable or not.

It's a tough problem. The Internal Revenue Service <u>does</u> have a responsibility to make sure that plans are soundly funded, and it does have a responsibility to make sure that the taxpayers are not ripped off by unreasonably conservative assumptions.

On the other side though, the guidelines have some serious technical flaws from my viewpoint. One which has been alluded to is that the assumptions which are reasonable in the short run (particularly the high interest rates we have been experiencing in recent years) do not appear in most actuaries' judgment as reasonable in the long run. Therefore, using assumptions that seem reasonable in the long run would automatically trigger these things.

The second is a technical flaw which has been brought to our attention very capably by Arthur Anderson. He mathematically demonstrated that, if one invested in a portfolio of common stock which had all of the characteristics of the Standard & Poor's 500, the same amount of variance and the same mean return over a ten-year period and if the actuary made the best of all possible assumptions that the company was going to realize the mean return that actually occurred in that time, you would fall outside the guidelines each year during that period. Has the IRS taken a fresh look at its guidelines in light of Arthur Anderson's criticism?

MR. WADE: We have looked at his criticisms and will continue to evaluate them and any other comments we might receive. As of now we don't see any real need for a modification in the guidelines because of his comments. There are things that can be done to smooth out or eliminate the types of problems Mr. Anderson suggested. For one thing, there are other asset valuation methods that can be used that would smooth out the problem of the short-term fluctuations in the value of common stocks. Thus, they may not have as wide a variation as in his example. In addition, not all portfolios are exclusively invested in common stocks as in Mr. Anderson's example. As of now, we don't see any reason to modify what we have done. Also, you may be able to justify some of this fluctuation as nonrecurring events. That would be our response.

MR. PAUL E. ENGSTROM: There are some technical problems with the worksheet particularly with respect to spread gain methods. These problems are not only with respect to new entrants under aggregate methods; the guidelines will often be exceeded because of the way that gains and losses are calculated.

MR. WADE: For spread gain methods, the worksheets have a way of handling it. We are looking at the changes in the normal cost percentage in a manner that is detailed in the worksheets. Also you always have the opportunity to go back under the entry age normal method to demonstrate that the assumptions are reasonable. Presumably, you will have the pieces you need--the actuarial liability and normal cost because they're needed to check the full funding limitation.

The guidelines themselves deal with past experience, so it's not clear what would be done in the first year of the plan. I don't think that because of this "anything goes" in the first year. I mentioned one particular case where the assumptions were challenged in the first year of the plan. It was a narrow set of facts where the only important assumption was the interest assumption. It was decided that the interest assumption was unduly conservative, and the assumptions were found to be unreasonable. That was in a technical advice memorandum that was published about a year and a half ago. The assumptions can be challenged the first year, but I don't see this being done a wholesale basis.

MR. STEVEN D. BRYSON: Like most consultants, we have to consider another practical aspect: who's going to pay for this? When I was at the session on Responsibility to Pension Participants, Mr. Leslie Shapiro of the Joint Board for the Enrollment of Actuaries talked about a particular situation that came up before his office with regard to a plan in which a Schedule B and valuation was done for 1978 but not for 1977 or

1976. The IRS requested that those schedules be prepared, and the plan sponsor refused to authorize the enrolled actuary to do those valuations.

I would like to read specifically from the manual under Chapter 700. It says under the Introduction in Paragraph 1, that "the agent will need to use the approximate cost adjustment guide if the taxpayer or actuary is unwilling or unable to recompute these amounts." If this is the case, depending on facts and circumstances, the specialist should consider whether the matter should be referred to the Joint Board for the Enrollment of Actuaries.

That places me in a dilemma because my client may not want to pay me another several hundred dollars to go through the motions required to defend the use of the actuarial assumptions (for a reviewer who may not be totally familiar with the use of the worksheets or recomputation of actuarial assumptions) chosen by the actuary to keep the last five-year plan experience within the 4 percent corridor.

The questions come down to this: If we do not choose to absorb the cost of the work ourselves but instead expect the client to pay for it and the client refuses to authorize us to do that because he doesn't want to pay the fee, would a referral to the Joint Board against the specific actuary be contemplated?

MR. WADE: You are talking about something the Joint Board might do whether or not a referral is made. It is up to the Joint Board to decide whether or not there was some kind of professional problem. That might be a question for them as to who should absorb the cost, you or your clients, or whether you have the professional responsibility to try to perform the valuation even if the client doesn't authorize the work to be done. I don't know. I should refer that question to the Joint Board. That's their issue. As far as whether or not a referral to the Joint Board would be made, all the facts and circumstances of the case would have to be considered.

MR. ENGSTROM: First, some of this activity generated by the guidelines is presumed to be trivial, and it isn't always trivial. One of the instructions say if it doesn't work out on a spread gain method, redo the valuation under the entry age normal method, and if it works out, you're alright. Redoing old valuations may be trivial or may not be. It depends on how long you have had the case, whether you have the data, whether you've changed computer systems, whether your old computer system gave you the information to work it out on entry age normal, or whether you have to go back in and re-create the whole thing. That brings up the point concerning cost. Who pays for this re-creation just to prove that everything was really alright in the first place?

Second, there is another liability issue. You may have selected your assumptions in good conscience. You may have done things that the Joint Board would have approved. Yet several years after the fact, the IRS might come along and dictate to a plan sponsor that he has to come up with the additional funding or that he has to refile tax returns and reduce deductions. (One of my client's reactions was "Well, Mr. Actuary, you were wrong. We acted based on your advice."

The actuary did what the Joint Board was happy with, and yet the IRS is coming along telling the plan sponsor that it's not good enough. Who's at fault? Where do the liabilities lie? Those are serious questions.

MR. LOSK: Those are good points. The question of undeserved actuarial malpractice exposure has been discussed with the IRS. To my knowledge, there have been no specific cases to date. If such cases arise in the future, some of the questions Mr. Tierney asked about the profession's response will need to be answered.

QUESTION: In many Sections of the administration of plans such as the 415 limits and equivalence factors, the IRS has given some guidelines of safe harbors--not just in pensions but in other areas of the tax code. Now that doesn't mean when you have a safe harbor that everything must fall within that range, but anything within that range is presumptive. Anything outside that range which can be demonstrated to be reasonable is acceptable. Could the IRS consider promulgating safe harbor ranges so that, if an actuary used a set of assumptions within that range, unless there was something grossly improper for some external reason, those assumptions would automatically be accepted, specifically with regard to the economic assumptions that are so highly volatile?

MR. WADE: That's difficult to do. Even if you were to specify a range for one assumption, for example the interest rate, there are so many other assumptions involved that you could have substantial gains and losses and still be within that range. We felt the best way to judge the assumptions was to look at the gains and losses. There is a proposal in Congress that would require, in addition to the assumptions being reasonable in the aggregate, that certain other assumptions would have to be reasonable considered on their own. I believe the interest rate is what is being looked at here. I don't know if that would accomplish what you have in mind; it would just add another requirement. We didn't see how that kind of system could work.

DR. KRA: In analyzing actuarial gains and losses, salary and investment return can easily be identified. The balance tends to be minor in relation to those two. It would be helpful if you were to promulgate safe harbors just on those two assumptions. Anytime there is a major gain or loss from demographics, there has either been unreasonable assumptions, or there has been a significant event, an event which had indicated change in assumptions for the future.

MR. WADE: Even though the economic assumptions are important, you can have wide swings in the cost by varying your turnover scale or varying your retirement age assumption. These assumptions can have as important an impact as your economic assumptions. We just didn't see a way to make a safe harbor range work. You could still have significant gains and losses even if you gave a certain range for the assumed interest rate and salary increases.

MR. TIERNEY: I wonder if this doesn't head us toward the question of specifying assumptions. It's a small step from a safe harbor concept to a specification of assumptions broadly. I suspect there would be those who regulate pensions whose lives would be made much simpler if actuarial assumptions were specified. Is that something that we could live with broadly for all plans, more readily than the set of guidelines?

MR. RALPH J. BRASKETT: I have to answer no. The Pension Benefit Guaranty Corporation (PBGC) immediate annuity interest rate will probably be in effect in the valuations for the Financial Accounting Standards Board by about 1990. I have many clients who for two or three years running have not made the PBGC annuity rate. So if this interest rate were specified, you would be setting my plans up to have big losses. Because of medium-size plans, I'm getting swings on my demographics.

I was recently reviewing the history of one of my clients. I noticed a pattern of losses every year from 1976 to 1980, 1983, 1984, and 1985. The reason was that, as the plan got more mature, and because the client was very prosperous in the 1970s and 1980s, he made maximum funding under entry age normal. He is just now starting to get investment gains for the first time passing his salary scale losses whereas in the 1970s, where the plan had a lot less assets in it, he was getting some modest investment gain with salary losses.

So if you look at the ten-year pattern and if you took any three years (except the middle three where the swing started to occur), a case could be made that my assumptions were unreasonable in certainly the short term. Since he was maximum funding in the early years, it didn't matter if you wanted to argue with me for Section 412 purposes. But if we're now raising revenue by fighting over Section 404, you could probably nail me on a very short-term period like three years. If we start looking at an eight-, nine-, ten-year historical period, we begin to see things balancing out.

My question is, what period is the examiner going to look at? If we provide information to show the patterns of the past eight or nine years, is that going to be taken into account?

MR. WADE: In general, the first step is to look at the gains and losses over a five-year period assuming that information is available. Now, if you feel a different period is more appropriate, that would be considered. The five-year period may not necessarily be cast in stone. If you can justify a different period, we will consider your reasons and make a decision on that.

DR. KRA: Many of us have noted the lawsuit, the PBGC vs. Buck, where an actuary has been challenged for not anticipating in his assumptions, an event which would have not shown up on prior gain/losses. If he had them in his assumptions and they were generating year-in/year-out gains because the event had not yet occurred, namely the company closing its doors, wouldn't that in itself cause a problem with the reasonableness of the assumptions? Are we going to be faced with the problem of the PBGC saying our assumptions are not conservative enough? And the IRS is complaining that we're overly conservative and hiding money from the revenuers.

MR. WADE: The lawsuit you're talking about dealt with a certain type of event. A plant shutdown normally would have a low probability and wouldn't have an enormous impact on your gains and losses. I'm not sure how that would enter into the worksheets and if it would cause much of a problem.