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SMALL PLAN DESIGN AND FUNDING ISSUES

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An open forum discussion of particular interest to actuaries dealing with small pension plans, including:
- o What are the unique problems of small plans?
- o Participation and coverage tests: case study
- o Funding assumptions
- o IRS audits
- o Benefit design

MR. STEVEN D. BRYSON: Let me introduce the members of the panel, starting with Elaine Wiant from Milliman & Robertson in Dallas. Next to her is Bob Bolin with Legette and Company, also here in Dallas. And next to him is Gary Short. He's with Akin, Gump, also here in Dallas. With that, I'm going to ask Elaine to get started. She's just going to give a general overview of what it is that we deal with in the small plan area. Bob and Gary are going to get into some specific circumstances that they ran into. Bob will give us an overview of Notice 90-11, and then I get to talk about IRS audits.

MS. ELAINE M. WIANT: What I thought I'd do is just go over some of the issues that we run into in designing small plans, if we ever get there.

The first thing that you need to decide when you're faced with a small plan client is whether a qualified plan is appropriate or not, and I think that's an issue that's come up more and more. Very often, we're faced with a client for whom whether or not to have a plan is the first thing that you need to talk about. What's the client's objective in having a plan? Is it to provide retirement benefits to the owner of the company? Is it to provide tax benefits to the business? Occasionally it'll be to provide competitive employee benefits. I know I've occasionally run up against a situation where the motivating factor really is to be competitive. Usually that's when you talk about a 401(k) plan, even with a very small employer. Every once in a while you'll need to have a plan just to attract employees.

Once you've decided on the objectives, then you need to look and see what percentage of the total contribution to a plan needs to go to the owners in order for it to be an acceptable, viable alternative. Maybe we ought to back up for a second and talk about what we're talking about when we talk about small plans. What we (the panel) decided

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we were talking about was tax shelter plans. It's not necessarily related to the number of employees but where the objective really is to provide something to the owner, and the employees are ultimately peripheral.

And then you have to decide what level of contribution they're willing to commit to. This is another issue that comes up over and over again: "Well, I've got a lot of money right now, but maybe next year I won't have any." I always try to get a commitment for at least five years' worth of contributions. "I can do $50,000 a year for five years, and I feel comfortable with that." Another question is, what's the expected time of retirement? How long do we have to meet the objectives? What do you think tax treatment is going to be at that time? What do we think tax rates are going to do? Nobody knows, but it's something to talk about.

And, lastly, is there a level of fee involved in this plan that would make it ineffective? You know, if you're going to have a little plan with a contribution of $5,000 a year, and you're going to charge them $1,000 to administer it, does that make any sense? It might make sense to us, but it probably doesn't make sense to the client, so we really ought to discuss it up front.

After we get through all of that, then what kind of retirement plan do they want to have? We're all actuaries, and, you know, we'd be really happy if everybody had a defined benefit plan, but that is not happening very often anymore. So, we have to look at defined benefit plans and defined contribution plans and then, within defined contribution plans, money purchase, profit sharing, 401(k), and target benefit, or a combination of more than one. (Target benefit plans are becoming more and more popular these days.)

So, let's assume that we decide that a defined benefit plan is appropriate. Then we need to talk about some of the design issues in a defined benefit plan. Maybe the first one is the normal retirement age. In this environment today, is anything other than age 65 an acceptable retirement age?

MR. RALPH J. HEALEY: I have a usual doctor plan, age 55, a 100% J&S, you know, all the usual bits, and he actually is going to retire in two years. He already has his missionary assignment from his church, where he's going to go do missionary work, and the IRS has accepted that.

MS. WIANT: Good.

MR. HEALEY: And 5% interest.

MS. WIANT: We'll get into some of those things in a little bit, I hope. The retirement age that you choose in designing a plan right now is a difficult issue, and I think it's certainly something that needs to be discussed with the client, that today, anyway, if you're going to put a retirement age in a plan of something other than 65, you need to be able to back it up. In my experience with these audits right now they're looking at actual retirement ages. If it's 10 years away, you're not going to know when you get your audit. So, if you're looking at somebody who's 45, and you choose a retirement age of

55, you may well be facing an audit problem that you can't justify. It's certainly something that the client needs to be apprised of as you're designing the plan.

The benefit formula -- do you want to integrate the plan? Is it worth the effort these days? Probably, I think, depending on your retirement age and some other things, it may still be worthwhile, it may not.

Actuarial equivalence assumptions -- what kind of assumptions are you going to put in the plan? Are you going to allow lump sums prior to retirement age? All of these are things that need to be addressed in defined benefit plans.

Some of the other things that we run into a lot are in the areas of coverage. A lot of times these small business owners have other businesses that they forget to tell you about. I think it's really important that we explicitly ask, maybe every year: "Do you own anything else? "What kinds of relationships do you have with other businesses?" They'll pop up at you out of the blue. And the issues of leased employees and affiliated service groups are always there to frighten you away.

Then we have the family aggregation rules that are easy to lose sight of, too, with our combined $200,000 limit and how to deal with that.

And finally, there are 415(e) considerations if you end up with more than one plan or you're trying to trade back and forth between one type and another. Those are the basic issues that I've run across in setting up a new plan.

MR. BRYSON: Let me just interject some thoughts that occur to me while I'm listening to Elaine. The small plan sponsors that we've dealt with in the past tend to be more the entrepreneurial types of personalities who have some very specific ideas about what they want to do and how they want to accomplish those goals. This kind of a person probably needs more guidance than he wants from you with regard to the administration of his plan once it's in place. Specifically, I'm thinking in terms of the investment of the contributions once they're made. So, it behooves us when we're helping these people to design the plans to make sure that they understand about the prohibited transaction rules, and about the prudent man rules. I don't know, maybe the prudent man rules don't apply if that person is the only one in the plan, but if there are employees involved, then the fiduciary obligations of ERISA certainly do come into play. If you've got somebody who wants to invest in penny mining stock or limited partnerships or east Texas timber real estate, or whatever it is, you need to make him aware of the risks that he is or may be involving himself in. You're not his watchdog; you're not his parent slapping him when he does something wrong, but you are his consultant.

MR. BOB J. BOLIN: I'm going to cover IRS Notice 90-11 briefly. On January 29 of this year, the IRS published Notice 90-11. It was entitled the "Full Funding Limitation, Calculations of the Current Liability, Possible Range of Interest Rates, Valuation of Nondecreasing Annuities." All of us know that for the 1988 plan year, we could not use a rate that was less than 8%, even though the spread got below eight toward the end of the year for plan years that started in November or December, somewhere in that range. Basically, as you'll recall, when we were all eating Christmas turkey, President Reagan

signed OBRA, which limited the maximum deductible contribution to 150% of the current liability under the plan.

At first many of us didn't exactly know what "current liability" meant. As time has come along, we have perhaps a little bit better understanding, even though there are a lot of questions that still remain. Anyway, this notice says that until further notice, for years that begin after 1988, the interest rate must be between a corridor of 90-110% of the weighted average of the 30-year Treasury securities. It further states that no interest rates other than these prescribed will be used. Now, you remember the law made some mention of insurance company rates, and apparently the Treasury's throwing in the towel on this and is basically just going to go with the 90-110% corridor, but we do not have an 8% floor like we had in 1988. You are able to use the "seven-something" which is now the minimum, I think, for all of the 1989 plan year.

With respect to the valuation rules, for the current liability we use the permissible interest rate together with any other actuarial assumptions that we're using for the valuation to determine the present value of the benefits that are payable at all possible ages and all optional forms, determined with a probability that such benefits will be paid. Of course the salary scale comes to mind. We can only use the salary increase to compute the increase in the accrued benefits through the end of the plan year. And I think you see that on the 1989 Schedule B, they've made a little place for us to show the increase for that plan year.

However, the surprise in this notice is the exception to the rule, that the value of our typical life annuities, or the "nondecreasing life annuities," can be determined by using the interest rate specified in the plan. If you have a lump sum of 6% or 5%, then you would use the plan rate to determine the value at age 65 and then turn around and use the OBRA rate for pre-65 or preretirement age. This, on some examples that I looked at, made quite a bit of difference. You're able to use a postretirement rate of that which is specified in the plan as opposed to something around 8%. The only problem is that we only get to use this for a short period of time. People like me had already given up on that anyway, and it can only be used for plan years that began prior to 1990.

The notice also contains an example of a plan that provides for full benefits after age 55, in other words, the typical subsidized early retirement benefit, and this example showed one where the assumption is that 50% of the people would retire at age 60 and take an annuity, and then the rest would take a lump sum at 65. As a result of the calculations that they did in the example, the current liability was approximately 30% greater than it would have been if we'd assumed that everybody was going to retire at age 65. So, they kind of went in between, Ralph, and assumed that half of them would do it at one age and half at another age. Ralph and I were talking the other day about his model that he had for these retirement rates, the rate at which people retire, and found out that the Social Security Administration is pretty close to the same thing. So, anyway, it appears to me that this has a bit of relief for years prior to 1990. Unfortunately, I don't think too many of us will be able to use it.

MR. BRYSON: Let me just, for those of you who may not have been at the session with the IRS the very first afternoon, that it was confirmed by Ken Yednock and Karen Krist,

the visiting actuary with IRS, that any interest rate for plan years 1989 and later, within the 90-110% corridor, will be "deemed" by the IRS to meet the requirement of being representative of insurance company contracts. That's sort of like a defense attorney stipulating to evidence that's being brought out by the prosecuting attorney or vice versa. I don't think that relieves the actuary of the obligation of selecting an interest rate which is representative of insurance company contracts, because that's still in the code, and there's nothing the IRS can do to take that away.

What it simply means is that today the IRS won't fight you on any interest rate in that range. But as you know, since the plans that we do now can be audited up to three years from now, that doesn't mean that they won't change their mind on what they will or will not fight us on in three years. Yes, it's been published, and that would certainly make your argument very strong at a later point in time, but I think we need to be responsible and cautious. I know that there are some actuaries who are suggesting that whatever interest rate we need to use in order to get the result the client wants is the one that we ought to use.

Our purpose, by the way, in case it isn't abundantly clear, is simply to bring up issues and to get feedback from you and to have a healthy dialogue. We're obviously not the ones who are establishing guides of conduct of any kind. So, please feel free to comment or disagree on anything that we're talking about here.

The one thing that still bothers me about 90-11 is what it doesn't say, and that's what benefits are included in current liabilities. I did not go to the Enrolled Actuaries' Meeting, but I did get the tape from the Schedule B Full Funding Limit session that Paulette Tino did, and it was very clear from that tape that the IRS has not decided whether preretirement death benefits, or preretirement disability benefits are includable in the definition of current liability. So, that's a decision that you have to make for yourself. Keep in mind that your decision may affect the PBGC premium calculation if you're using the alternative method, because whatever you calculate for current liabilities goes on the 1989 Schedule B and would, therefore, be used in that variable premium portion for that calculation.

MR. GARY G. SHORT: It's kind of late in the week, and you're all ready to get out of here by now or at least waiting for the Mirza discussion so you can vent some frustrations. What I wanted to do is go through a case study that a couple of people involved in the panel were associated with, Bob Bolin and also Stan Tannenbaum who's not here but was an actuary involved in this situation. He's the one who organized this panel. We were all sort of brought into a system, the restructuring of some benefits plans, involving a large law firm.

So, we've got a small plan in the sense that Elaine referred to earlier where you're really trying to benefit the key employees, but it also involves a fair number of individuals. The firm had offices in a couple of different cities. They had staff consisting of the secretaries and the back-office personnel. They had associate attorneys. They also had partners which were in two categories -- those that were incorporated and those that were not. The incorporated partners tended to be the relatively highly compensated

partners, although not in all cases, and then the noncorporate partners tended to be the younger and less highly compensated partners.

The general structure of the plans consisted of an integrated defined benefit plan for the staff with no partners or associates in the plan. (It was a fairly standard deferred benefit (DB) plan.) There was also a profit sharing 401(k) plan that covered both the staff as well as the noncorporate partners. That plan allowed the individual partners that were participating to make discretionary contributions subject to the section 415 limits as well as comparability. There was no match provided. Remember, the staff members were getting their basic benefits out of the DB plan so that the 401(k) was just in addition to that. It also excluded associates. In law firms, associates are the young attorneys straight out of law school. The theory is that they're more interested in current dollars rather than retirement dollars at that time.

The plan had the risk of being top heavy, and in fact, probably did become top heavy, so they wanted to exclude them because it would be expensive to cover them, whereas the staff could be in it because they were getting their top heavy benefits out of the DB plan. Associates would not. So, associates were not participating in any plan. Then the P.C. partners, the corporate partners, all had individual defined benefit plans, and some of them additionally had money purchase plans depending on their compensation level. I think there were about 50 DB plans and maybe 20 or 30 money purchase plans. Well, obviously Tax Reform Act (TRA) 1986 came in, and it was going to require some changes.

In addition to the qualified plans, the firm also had a nonqualified plan which was basically just a provision in their partnership agreement that said that when you retired you got 200% of your "high five compensation," payable over 10 years, up to a maximum of $500,000. So, it was really $50,000 per year. That was completely unfunded. I think at one time they may have had some universal life insurance that might have been used to provide benefits, but basically nothing formal was being done to fund the benefit.

Well, then with the Tax Reform Act, 401(a)(26) came in. All the individual plans obviously had to be terminated, which was an interesting process because of trying to explain to people how reversions work and how much can be rolled over and why it has to come back to the professional corporation, (these corporations were S corporations) and how that gets passed back to the individual. A lot of these people are litigation-type attorneys who know nothing about numbers or about pension plans or anything else, and yet they're trustees of their own plans. Bob got to spend a lot of time dealing with this. With the change in the law all those plans had to be terminated, and then we had to come up with a new structure. Bob's going to talk a little bit about the new qualified plan structure that was put in place, and then I want to follow up a little bit with the nonqualified plan that was put in to replace this prior one we just discussed.

MR. BOLIN: I suppose that 401(a)(26), with its 50 participant/40% rule, changed the life of the actuary as fast as anything I know, especially with all of these affiliated service groups. We find that some firms are large enough to have separate plans for the staff and for the partners. Others aren't. So, depending on the size and the demographics, the type of design that the affiliated service group ends up with is largely dependent on

its size. I guess some people might say that the simplest thing is to just put everybody in one plan and forget it. But when you're dealing with individuals who all have egos, that doesn't always work out too well because you get into the old group versus the young group. So, you'd end up thinking that about the only thing that's going to cure this sort of situation is to go with some sort of an account-type plan. And then I guess people are always worrying about who's paying for whose benefit and things like that.

So, what we ended up with in our new design, after many months of study and thinking about different solutions, was a defined benefit plan for the core employees. This plan provides about 50% of pay, offset by the permitted disparity under 401(l), for anybody that's got 30 years of service. So, it's a nice benefit plan for the employees. The plan, of course, has the six year, top heavy vesting schedule. The plan is top heavy, not super top heavy. The top heavy benefit is provided in the defined benefit plan of 3% of final average pay for the first 10 years. This permits the use of the 125% rule under 415(e). The plan contains loans because we wanted to make sure that this plan essentially has all the little bells and whistles that the plan has for the partners.

Loans, as you know, are not a positive thing to have in a DB plan, anyway, because when employees leave, then you have to get their money, or send out nasty letters telling them that if they don't pay it back, then we're going to end up . . . So, what you end up doing is having to send them all kinds of paperwork and do a 1099. But, anyway, it was felt that all the provisions should be as close as possible to the provisions of the plan that the partners had. There's also Plan #2 which is a 401(k) plan that's for everyone, all the staff and all the partners, but not the associates.

In order to get good participation we do match contributions for the staff. It's worked out quite well. Probably about half of the partners are participating in the 401(k) plan and probably 30% of the nonhighly compensated employees are participating in it. Of course it has the top heavy vesting schedule. The top heavy benefits are not provided under this plan since they're already provided under the defined benefit plan, and there is directed investments permitted in the plan for everyone. You have to provide it for all. So, the rank-and-file employees are in the defined benefit plan and in the 401(k) plan. Then for the partners, the primary plan, or what we call the mandatory plan, is a target benefit plan. As Elaine mentioned a while ago, target benefit plans are gaining in popularity. The target benefit plan would hopefully provide about 37.5% of pay or approximately $75,000 per year at age 65, assuming the $200,000 cap on compensation. Thirty-seven and a half percent times 200,000 should be 75,000. However, we still have the great disparity in the old target benefit regulations where you can't use what, greater than 6% interest? And has anybody heard anything, whether they're going to change that any time soon? Targets are always the last thing that ever gets changed by the IRS.

MR. BRYSON: Well, it seems like they don't even know what they're going to do yet with them.

MR. BOLIN: Right. So, in the meantime you live with the old 6% rate. So, in view of that, we lowered our formula from 37.5, based on the average ages of most of the partners and everything, down to 25% of pay for 25 years of service. The contributions are then calculated using the 1983 mortality table and 6% interest for a 25%-of-pay plan.

Likewise, it has the six-year top heavy vesting schedule. Some day we feel like we may not be top heavy in this plan, when the magic number of older partners who go on to beyond the five year, look-back provisions is reached. We keep hoping that top heavy will go away because of the dual administration. The benefits will be paid out in the form of a joint and survivor annuity, if you're married, otherwise it'll be paid out in the form of a life-only benefit. These are the same sort of provisions that we have in the defined benefit plan.

Obviously, the deductions for the target plan are affected by two very important things. First, 415(e) of the Internal Revenue Code. Generally, for a lot of the older partners, we have to look back and see what they had under the prior benefit structures, but I think you'll generally find, in a large law firm, that many of the guys come in rather young, and they have a lot of "backservice" with the firm. So, this helps a lot on the 415(e) problems. And then, of course, the last one is comparability under Revenue Ruling 81-202 and its successor which we've heard is supposed to be out by April 16, right Elaine?

MS. WIANT: I don't know about comparability.

MR. BOLIN: Well, as for the new 401(a)(4) regs or whatever, I have done a lot of comparability demonstrations for the Internal Revenue Service in both this office in Dallas and the one in Baltimore. And, you know, I've never had any comments from any of the guys. They just want them. I don't know if anybody else has had that same experience or not, but as long as you seem to follow the spirit of the regulations, I've never had anybody to question what I've done.

The other plan that we have is another defined contribution plan which picks up what the other one doesn't. A target plan for the very young partners (in this law firm you make partner about age 32, age 33, most of the time, or maybe younger) doesn't give a very large deduction for these younger guys. So, we ended up with a plan that provides for 15% of partners' compensation less the amount that you've already put into the target plan. So, really they're like one plan because of the fact that the contribution to both plans would have to be proved comparable to the defined benefit plan of the rank and file or core employee. This plan contains essentially all the same features as the other plan does. When we first started out we just had the one plan, but we ended up with two plans because it ended up giving more flexibility with respect to the partners' retirement plans. Some are more interested in retirement plans than others. So, either you're in it or you're out of it for your whole life.

MR. BRYSON: Now, Bob, in this kind of a situation isn't it true with a partnership that this has to be a uniform program for all the partners? They can't elect as to whether to participate or not? Otherwise, it would make the whole thing subject to the 401(k) rules.

MS. WIANT: One-time election.

MR. BRYSON: Oh, you can have a one-time election to elect out.

MR. BOLIN: You're either in or out. As I said, you're in or out.

MR. SHORT: On the mandatory plan, the target plan, everyone is in, except I think the only people that could opt out of that were age 60. And then on this "sponge," or "soak-up" plan, a one-time election in the first-year, and that's for the rest of your career, unless the IRS changes the rules and allows us to make another choice.

MR. BOLIN: We think it's ok.

MR. SHORT: So, that's the qualified plan structure.

Originally, the nonqualified plan was limited to $50,000 per year for 10 years, and so once the decision was forced upon the firm to look at the qualified plan structure, then a decision was made to go back and revisit the nonqualified portion. The original idea was to make the nonqualified plan follow the target benefit idea of the 37.5% of compensation for life so they'd get the first 75,000 out of the target plan, and then they'd get the rest of it out of the nonqualified plan. Also, originally there had been no funding for this $50,000 benefit, and it was recognized that over time, that was going to catch up with the firm, and so they needed to begin setting some money aside in one form or another. Whether it's some sort of Rabbi trust type arrangement or just separate accounting or buy some insurance or some other vehicle they needed to fund it. When this first proposal came back, then, there were two problems. The way it was couched at least originally was it was going to create a huge liability, and if it's set up in sort of a defined benefit type form, 37.5% of compensation for life, you've got potential liability both to the firm and to the individual partners, which created a little bit of concern. You know, if the investments didn't go so well, who was going to sue whom, and you don't really want to create a structure where people are going to be going after each other. The second concern had to do with the wealth transfers associated with putting in any sort of a plan like this. If you've never funded, all of the sudden you've got partners who are 55 or 60, and you come in and amend the partnership agreement and provide that these people are going to get 37.5% of compensation for life, and yet nothing has been set aside previously, some of the young people were not real crazy about that result, particularly in the historical context where everyone paid for their own retirement through those individual plans.

So, we had a problem at that level, and then there was sort of a further problem at the same sort of level that if the nonqualified plan is going to be offset by the 75,000 out of the target plan, and someone's compensation ended up being only at, say, 200,000 when they retired, for some period of time, they're going to be paying for the nonqualified plan, and yet when they ultimately retire, they weren't going to get any benefit out of it. To some degree I think that problem's sort of inherent in any kind of defined benefit relationship in small plans. If someone's going to get a large benefit, they're going to pay for it, and in the small plan context where you typically just have a few owners, you've got that kind of dilemma constantly. Anyway, various alternatives were explored, including individual accounts. The problem with the individual accounts is that for the older people, there just simply wasn't enough time to accumulate the kind of benefit that they really wanted to get out of it which is another way of saying that in order to make the thing work, there had to be some sort of transfer of wealth, but you had to hide it a little bit to make it so it's not quite so blatant.

And another aspect of the nonqualified plan was to try to create sort of a golden handcuff idea. Law firms seem to be much more mobile now than they have been historically. Partners go from one firm to the next, and this firm wanted to try to provide incentives for people, particularly older people who had large blocks of business, to stay, and so, one aspect of the nonqualified plan was to try to combine it with some sort of a noncompete arrangement or at least a very, very long vesting schedule so that it'd be hard for anyone to get this benefit if they left. Unfortunately, a case came out of New York within the last year that basically provided that noncompetition agreements weren't enforceable under some of the professional rules that the lawyers are subject to, and different states have different rules, and so you'd have to look at your particular state situation to see what the rules are. But there's a normal situation of rules that most of the states have adopted. You've got problems with noncompetes. And so there are certain problems with the golden handcuff idea in these situations, but that was one desire on the part of setting this thing up.

Ultimately what was created was, I think, a fairly unique plan, and I don't know exactly how to label it. Bob, you can jump in at any time. We're sort of calling it a "benefits available" plan, and in essence, it's a defined contribution plan, but it has a little different form on the allocation method. It's also integrated to some degree or offset by the qualified plan. Basically, there's no promised benefit to anyone. They're not guaranteed any benefits. So, we don't have this problem of the recourse liability to either the partnership or the individual partners. The only benefit that anyone gets is whatever funds are in the funding vehicle, whatever assets are there, so, hence, the benefits available idea.

The question, then, is how do you determine what an individual's benefit is going to be? The basic idea was to let the dollars in the fund determine a benefit percentage, and you ultimately come out where it's going to be "x" percent of your compensation over the 200,000 that's taken into account in the target plan, with the 200,000 being indexed in the same manner as for the target plan. And if sufficient assets happen to end up in the account due to good investment return or compensation doesn't go up very fast or high mortality, then you actually could conceivably get up where "x," this benefit percent, ends up being the 37.5% that was originally desired. But I think it's exceedingly unlikely that's going to happen. Obviously, it depends on what gets contributed. And so the benefit that you get, you actually back into by using actuarial assumptions that are based upon whatever the experience of the plan has been in terms of investment results as well as compensation increases and turnover and the like. By creating the plan this way where you back into the benefit that you get, based on what's in there and the actual experience, you end up in a situation where you can never be either under- or overfunded. I mean your funding is always exactly right. The problem is you don't know what you're going to get in any particular year, but at least there's not an issue on over- or underfunding.

The way the plan was structured, there was a 4% accrual per year. So, it takes 25 years to get accrued in your full benefit percent. There's also a 10-year vesting plan, and then there's some mechanisms with normal retirement, and decisions on the noncompetition are still being considered. The ideal way would be that no one can leave and take their money until, say, 65, if they're going to go compete, with maybe exceptions for things like

governmental service or going to teach or something like that where you're not really effectively competing, or maybe if you go to a different city where you can't compete, you'd be able to get the benefit.

The decision on funding was to say that the firm would contribute 4.5% of the partners' profits, but that includes the contribution that goes into the target plan which basically turned out to be about 3%. So, you end up with about 2% going in for this nonqualified plan, and depending on what you assume the earnings are going to be and how compensation is going to increase, that'll buy a fairly decent-sized benefit. The benefit percent, then, is calculated annually. When a person retires you back into his benefit percent, and that's what he's going to get. That can go up or down a little bit with experience, but the feeling was that once you retire, you shouldn't be at risk for bad investment results or poor funding that the succeeding generation or partners in the succeeding years have. So, your benefit percentage gives you sort of a first claim on the assets in the trust. It still doesn't give you any ability to go back against the partnership generally or back against the individual partners, but it at least gives you a prior claim to the assets of the plan. Anyway, that's an unqualified plan. I'd be interested in any comments that people have as to whether they've seen something like this or how it's going to work. We've spent a fair amount of time thinking about it, Bob and a couple of other actuaries who were involved, and I think it has some prospects for success, but it is a little different, basically a defined contribution plan where you back into the benefit using defined benefit type methods. That's it. Has anyone seen something like this?

MR. BRYSON: I don't want to pretend to be an expert on IRS audits of small plans, but somebody on the panel had to talk about it. You may know that the moderator's not normally supposed to have to deliver any kind of a speech, but this was one that I am interested in simply because I've been involved in a couple. Generally, if you really don't know what's happening, and I rather suspect that everybody here does, but just for the record, the IRS has a program right now of targeting certain defined benefit plans for audit, the purpose of which is to disallow contributions. I don't mean to be inflammatory by that statement. I know that Brauer has publicly said that this program is not revenue driven, but I think with our "read-my-lips" President wanting to raise revenue without raising taxes, that this is clearly a revenue issue. Anyway, the targeted plans are defined benefit plans that cover one-to-five participants with deductions of approximately $70,000 or higher. You may have heard some higher or lower number than that, but that's generally the size of the deduction that they're looking for. In other words, if there's a tax return filed that falls within those parameters, those seem to be the ones that are being pulled for audit right now. According to feedback that I got from individuals who went to the Enrolled Actuaries meeting, the IRS is anticipating raising $700 million from this program over a three-year period. What they are basically doing, of course, is challenging the reasonableness of the actuarial assumptions. Their guidelines are to challenge any such plan that I previously described with an interest rate of under 8% and/or an assumed retirement age of under 65.

Now, you may be aware that there were a couple of memos that were directed to the IRS field agents that came from the Washington IRS office. The first one said any plan with an interest assumption less than 8% or an assumed retirement age under 65 is unreasonable, and you should challenge it, and unless -- and now what I'm telling you is

what the IRS agent told me -- unless the actual return over a five-year period was under 8%, that you should refuse to accept any valuation rate under 8% and that there was basically no circumstances involving the medical profession in which retirement ages under 65 were to be allowed. Apparently the AMA did their members a great service by doing a survey and finding out that the average retirement age for physicians was over 65, and the IRS jumped on that. By the way, previously, the rationale for challenging retirement ages under 65 was that the average retirement age of the population was 65. That's what the IRS was saying a few years ago. Since then, surveys and statistics coming out of the Social Security Administration System, the Civil Service Retirement System, and certain large benefit plans have actually shown the average retirement age of the population as a whole to be lower, probably at a median of around 62. Nevertheless, this evidence is apparently not relevant to this particular IRS program.

Now, the way this works, if you haven't gone through it yourself, is that this plan will be picked up for review. The agent that you might be dealing with is going to be an employee benefits agent. In other words, he's going to be in the EP/EO division. He's going to review the 5500-C or -R. The ones that are being audited right now are for plan years ending in 1987 and 1988. You'll get a nice long letter listing all the things that they want, including copies of the 5500 and Schedule B for the last five years, as if they hadn't already gotten them. They apparently don't keep them or at least they keep them somewhere where they can't find them. So, you have to give them copies of what you've already filed. Anyway, one of the things that they will ask for is the actuary's or taxpayer's arguments supporting the use of the actuarial assumptions. That's your key that they are going to be auditing the actuarial assumptions. They will then get all the information from you and do a contribution calculation. They apparently have a PC-based program that was given to them by the National Office where they can input the basic information on a one-person-at-a-time, iterative type method and, first of all, use your assumptions to try to reproduce your numbers and then use the age 65/8% assumptions to propose a disallowance of the deduction. You then are given the opportunity to discuss or dispute the agent's calculation. My experience with this particular agent was a lack of understanding of basic actuarial mathematics. It was truly a cookbook approach to the valuation that this person was doing, and I don't mean that in any way to be critical of the individual. Given the tools that he had to do the job, he did do an excellent job, and he was very pleasant the whole time.

In any case, he wasn't aware of the differences between beginning-of-year and end-of-year valuations and wasn't aware, for instance, of actuarial adjustments for commencement of benefits before or after the plan's normal retirement age and so on. So, when you run into this person with regard to your own plans, you will need to do some explaining. It's my advice to you that you be very civil and cordial and helpful and friendly about it. I was all of those things. It didn't do my client any good, unfortunately.

Now, here's one thing that I have since learned that you can do, although the agent and his manager did not inform us of it while we were in this process, and that is not only does the agent have the ability to confer with Washington to determine whether the facts and circumstances of your plan may warrant deviation from these standard assumptions that they've come up with, but that you also have the right to request it and even

demand it, and there are procedures involved for when they're unwilling to do so. So, you should be aware of that. I'm sorry I don't have the personal experience to give you any advice on how to go about it, but you should just be aware that you can fairly forcefully demand that if you feel your facts and circumstances warrant a deviation from the standard, that they confer. Another possibility that you may have is to call the IRS actuaries directly. Unfortunately, the only way that works is if you happen to get directly to the actuary. If a receptionist intercepts the phone call, you'll be told firmly, politely, I hope, that you have to call the taxpayer information hotline, and if you have the same experience I do, you know what your chances are of getting through, and then if you get through, you know what your chances are of talking to an actuary.

After you have gone through the process of trying to convince them that what you've done is reasonable and have failed, you can, as they put it, agree to disagree. The agent will then write up a report and refer it to the examinations branch for collection of tax. In the meantime, the IRS may request the taxpayer to sign an agreement to extend the statute of limitations on the 1120 if the IRS feels like the appeal process may take it beyond the three-year time limit. You don't have to sign it, by the way. However, if you don't agree to the extension, then they will probably send you a 30-day letter for the collection of the tax in which case you then do have 30 days to pay the tax whether you appeal or not, whereas if you sign the agreement, that is, if your client, the taxpayer, signs the agreement to extend the statute of limitations deadline, then, you can then wait on paying the tax until you've exhausted the appeals process.

MS. WIANT: If the taxpayer does sign the agreement to extend the statute of limitations, you want to be sure that they limit the scope to that item.

MR. BRYSON: That's right.

MS. WIANT: You don't want to have them sign an agreement to extend the statute of limitations on their entire return.

MR. BRYSON: That's right. They will ask for an extension on the whole 1120.

MS. WIANT: And you have to ask for that. So . . . It's not something the IRS offers. You have to insist.

MR. BRYSON: Now, the point of the process from this point forward is really what are the legal avenues available to the taxpayer? Whether a lawyer is involved in the audit process up to that point or not, it really becomes imperative at that point for the taxpayer to have legal counsel from that point forward. There are a number of attorneys out there who practice in ERISA areas but don't have any litigation experience, and there are those who have tax and litigation experience who don't have ERISA experience. It's really best to find someone who has experience in both areas or to find a law firm with two lawyers, one who has experience in each area, to make sure that everything is adhered to and all the rights of the taxpayer are preserved as much as possible. Of course all of this starts to get expensive, and I think that's part of the reason why the IRS is targeting the small plans, because the general attitude of the taxpayer is going to be, "I don't want to spend a lot of money and a lot of time litigating this if I can get

some kind of a compromise with the IRS and only pay maybe $50,000 instead of, the whole amount that they're disallowing. I may be willing to do that."

A couple of ERISA attorneys that I have been speaking with on a number of these cases have pointed out that there are two avenues as far as going to court is concerned. One is tax court. One is federal district court. If you go to tax court, you don't have to pay the tax until the case is decided. However, the interest on the tax, and the penalties, keep accruing. There may be some circumstances under which the taxpayer may be able to post a cash bond to stop the accrual of the interest under that circumstance. If they go to federal district court, then the taxpayer must pay the tax and then sue for a refund. So, tax court, no payment. Federal court, payment first. The opinion of these attorneys that I've been talking with is that a tax court is generally more favorable to the IRS than the district court. So, the amount of money and how vigorous you want your defense to be will have an affect on which route you expect to take.

MR. SHORT: There are actually three courts. There's also the claims court which is a little bit different but has the same rules as the district court in the sense that you have to pay. Generally, tax courts are more technically proficient to the degree that the argument you want to make is a technical argument, and if you think you're correct, you're better off in tax court. You don't have a jury which is bad to the degree that the arguments you're making are more equitable. You're probably better off in a district court where you can get a jury. To the degree that you have no equitable or legal argument, you're probably better off in claims court. There are three roads to go, and it depends on exactly what your issue is, and you need to look at the legal precedents in the particular courts, and where you're better off depends on the district where you are.

MR. BRYSON: Before I get into any details of particular situations, I just want to point out to you that there are some people on our side who are trying to do something about this. The American Society of Pension Actuaries has been vigorously protesting this. They've sent letters to the IRS and to Pickle and LaFalce. As far as I know, LaFalce has written to Goldberg, who's the IRS commissioner, demanding explanations for why they're targeting small businesses. Basically, it's difficult to know who's telling, "the truth, the whole truth and nothing but the truth." The first memo that came out, as I said, basically had a very hard and fast rule. After these letters were written to IRS there was then a clarifying memo that came out that indicated to the local agents who were reviewing these cases that if they felt like there were facts and circumstances to be considered, that they ought to contact certain individuals in the actuarial branch in Washington, D.C. to see whether the rules could be bent. Now, my personal experiences and the experiences of those with whom I've spoken, at least prior to coming to this meeting, were that the second memo was pretty much window dressing. The agent that I dealt with was basically not willing to consider the facts and circumstances, although, like I said, he listened very politely. I'm going to ask Elaine to mention a couple of things about her experience, but other than from her, I haven't heard about any audits which have been closed in favor of the taxpayer that didn't use the 8% and age 65 actuarial assumptions. So, I think what it is is we've got Washington who's trying to say one thing to maybe calm the masses, whereas what's going on in the local field offices may not be the same thing. Elaine, would you please share with us some of your experiences about this?

MS. WIANT: We probably have about a dozen cases right now that are in the process and in our office. I've had several either closed or recommended for close without any adjustments, none of which used an 8% interest rate. I've never used an 8% interest rate in a small plan. The retirement age situations that we've had that have been dealt with favorably are two basic situations, one similar to the one you heard about where the person actually retired at the assumed retirement age or close to the assumed retirement age. I had one case where the assumed retirement age was age 62, and he actually hasn't retired, but he's retiring next month, and he's not 63 yet. The plan was terminated due to 401(a)(26), and the assets of the plan were insufficient to cover his accrued benefits. On the face of it, it's obvious that the assumptions were not unreasonable because the assets were insufficient, but that's irrelevant. I mean that's clearly irrelevant from the IRS's perspective. However, in this particular case I pointed out that the guy actually is retiring from the company, sold it to some of the other employees, and he doesn't own it anymore, still works there for the moment, but he's retiring next month. So, she said ok. We have not heard back yet on the interest rate assumption on that case. I only know for sure that they said ok on the retirement age. And in my opinion clearly the interest rate assumption is ok, too, because there weren't enough assets in the plan when the plan terminated, but that doesn't seem relevant.

We've had a couple of other cases that I haven't worked on, that somebody else in the office did, where the plans have also terminated, and the assets have been distributed, and Ken Black was reviewing some of these cases, and apparently he has allowed them to say that if the plan terminated, and the assets were distributed, then the retirement age assumption was ok. It's beyond me to understand why we can look back now and say it was ok. It doesn't seem relevant to me that because everything turned out ok, that makes the assumptions ok. We are trying to make assumptions, and we don't know how it's going to turn out, and they're coming back and saying, "Well, since this is what actually happened, then it's ok to assume it," but that's what they're saying.

MR. BRYSON: Well, let me describe my experience to you. I have two doctor clients, part of the same medical practice. One had a plan that had been in existence for about four and a half years. The other one had been in existence for about three years. They were both terminated effective June 30, 1987, against my recommendations, because the clients' CPA was afraid of being subject to any provision of TRA 1986, even though these plans would have been allowed to continue to fund and so forth. They had an irrational fear of the change in the law. So, they terminated the plans. Both of them were, however, nearing retirement and concerned about how much of their share of their clinic's profits that they could save for their retirement. So, they asked me what they could do to come up with a higher contribution for the year, and one of the things that we felt was reasonable was to use an assumed retirement age of the plan termination date because that is, after all, when the benefit was going to be paid.

Now, in the case of Dr. A, the normal retirement age in the plan during 1986 was 65 and during 1987 it was 64. June 30, 1987, the plan was terminated and the assets were distributed. The doctor was 64.5. During the approximate four and a half year period during which the plan had been in effect the average rate of return according to the IRS's formulas, which is a dollar-weighted type return and then weighted by the number of months for each period, was 8.5%. The actual return fluctuated wildly because he was

in equities. In the first fractional period of a plan year, the return was around 5 or 6%. Then there was an 8% year, a 17% year, and then in the final year the plan lost money at the rate of about a negative 1% return for the last year. This all occurred before the last valuation date. It was my judgment, and you can agree or disagree if you want, that the actual experience of the plan was not a good indicator of anticipated experience because of the changing nature of the asset mix. Besides, the plan was terminating, and the assets did not exceed the accrued benefit present value. The IRS gave me no grief about using the plan's lump sum assumptions to calculate the value at the assumed retirement age. It was simply a matter of what was the appropriate preretirement interest and retirement age assumptions. So, anyway, after all of these explanations and calculations or whatnot, they, nevertheless, did a calculation based on an assumed retirement age of 65 and 8% interest rate. Because we were using the Individual Aggregate funding method, that resulted in there being two funding periods instead of one, so it reduced the deduction by about half. The other doctor's normal retirement age was 61, and when the audit first commenced, they told us that we were going to have to use 62 because that was the assumed retirement age in the prior year.

Regarding the average return on investment, it was well in excess of 8%, but we only had three years of experience as of the valuation date. I don't know if you had the foresight that I had in 1987, but I didn't expect the IRS to ever challenge a 7% interest rate. All of the plans that they had been going after out in California used 5% interest assumptions when Treasuries were earning 12%. You'll remember that the IRS imposed an 8% assumptions on those. So when we used 7% during a period when Treasuries were earning 7.5-8.25%, we thought we would be safe.

As we progressed through the audit, the memo came out. Our audits started before the memo came out, and when the memo came out, the agent said, "Well, now, you know this memo says we're supposed to use 65 as the assumed retirement age, but we're going to let you keep 61 because that was the directive that we had when we started the audit, and we're not going to change on you midstream." By the time we got to the group manager conference (a telephone conference which includes the agent, his supervisor, and me), it's a different story. They change their mind, and now it's age 65 again. For one of the doctors, about 75% of his contribution is being disallowed, and for the other one, about 50% of the contribution is being disallowed. We're talking about fairly substantial amounts of money here. I don't feel free to tell you what those amounts are, at least not publicly, for confidentiality reasons, but they are substantial amounts of money. By the way, this took place in the Nashville district office. The people in the Dallas key district office have listened to my description of the facts and circumstances and have said they wouldn't have raised those issues if they were doing it.

MS. WIANT: I think it depends who you get in Dallas.

MR. BRYSON: Well, I was speaking with the chief of the EP/EO branch, Preston Butcher. I've also discussed it with a couple of people from the IRS here at the meeting, and they thought that they were reasonable facts and circumstances situations also. So, it's possible that when we go to appeal that we may be able to get more favorable results than what we have gotten so far with just this particular agent and his manager. Before I go on and talk about a few other issues, I would like to pause a minute in case anybody

in the audience wants to share their experiences or just comment about anything that we've gone through so far.

MR. THOMAS D. BURGESS: I'm looking for some understanding. The use of the normal retirement age prior to 65, in theory shouldn't that only accelerate the deduction?

MR. BRYSON: Yes.

MR. BURGESS: And, in fact, once the normal retirement age is reached, given that it's also the assumed retirement age for the annual valuation, even if the person does not, in fact, retire, the money sits there, and in theory there should be no more funding, no more deduction, because by that time you've accumulated all the money that you need?

MR. BRYSON: To the extent that there are no losses that require continued funding, yes.

MR. BURGESS: Do you think, then, that it's not so much the acceleration of the deduction but the cushioning against investment losses and the implications that it has? Is that what is bothering the IRS?

MR. BRYSON: Well, what they're saying is that it has to do with timing as well as amount. In other words, they're looking at each year on its own, and it's not relevant whether the deduction that you could have gotten in the following year would be equal to what they're disallowing now. They're only looking at one year at a time.

MR. BURGESS: So, then, it's primarily the acceleration . . . .

MR. BRYSON: There's some rationale for that because of the changes in tax rates from year to year and interest adjustments and so forth, but, you know, it's not an unsinkable ship.

MR. BURGESS: Again, continuing just out of interest, to try to understand this, this may sound silly, but I'm not sure what retirement means. Do you have to stop working to start collecting your retirement benefit under a qualified plan?

MR. BRYSON: That's an excellent issue, and I raised it with the IRS when we were going through and discussing this. Of course, a qualified plan can make distributions as of the normal retirement age even if the individual works past the normal retirement age providing the plan says that it will be paid. In other words, to make an in-service distribution on or after the normal retirement age is not a disqualifying event in a defined benefit plan. However, this is not a qualification issue with the IRS. It's a deduction issue, and the position that they said they were taking was that an individual doesn't retire until he stops working.

MR. BURGESS: That's an IRS position. That's not statutory, is it?

MR. BRYSON: No, not that I'm aware of. That is what the IRS says. You see, during the telephone conference, they had another man on the phone who was an actuarial specialist. I guess that's someone who is given the job of doing the actuarial calculations but is not necessarily a credentialed actuary. Anyway, we were talking about this issue of what's assumed retirement, and the fact that, from our perspective, as long as ERISA says that we can retire at 55, and the qualification rules do not prohibit the payment of the benefit before 55, there ought to be a reasonable funding method and reasonable assumptions to fund for the date when we know the plan is going to be terminated by the owner of the plan and the assets distributed. And his answer was, "Well, if that was the rationale, then we wouldn't ever be able to challenge your retirement age assumption, would we?" I could tell by the tone of his voice that he thought that was an efficient refutation of what I said.

MR. BURGESS: Although I think you have to be careful that you do intend it to be permanent, you know, and, in fact, if you're going to close it out within the first 10 years, you better be sure you intended it to be permanent when it was set up, or I think they can take away everything. That's a qualification issue.

The idea about taking your retirement benefit while you are, in fact, still employed -- the comments you and I had here, that's in no way dependent on the small plan. I mean that could happen in a large plan.

MR. BRYSON: Oh, of course.

MS. WIANT: I just want to point out, too, that age 65 is no particular safe harbor. I've got a plan that's being audited out at the Philadelphia office, and the agent told me on the phone that age 65 was too young for me to have used as an assumed retirement age. The plan in question has been in existence since 1969. It has an age 65 retirement age. There are two participants. The wife may not have been in the plan since 1969, but she's been in the plan for a long time. And the plan's terminated now. She turned 65 in the year of the audit, and the agent is saying that I should have assumed some later retirement age because they're clearly both still working.

MS. MARILYN DUNSTAN: I really can't agree more with the discussion about what is the retirement age and looking to what is actually allowed as far as a qualified plan. I mean there's no prohibition on a retirement age under 65, and I really can't see how they can justify challenging this unless something is actually put in the statute to prohibit earlier retirement ages. I can understand that it might be a tax issue to allow deductions and to allow people to retire at an earlier point in time and perhaps be working at another job, but that's something that should be addressed through the legislative process.

I guess a further point that could be made is as to the assumptions, as to the interest rate assumptions, I was curious as to whether they're looking just at the interest rate assumption or are they looking at salary scale assumptions in conjunction? Because I know a number of people will use a low interest rate assumption and no salary scale, and on an implicit basis you might be ok. On an explicit basis maybe not, and I was wondering what people's experiences were on that.

MR. BRYSON: Well, in this particular set of plans, there was no salary scale assumption because both of them had earned income large enough to be at the 415 limits anyway, even without assuming increases. What I understand from hearing comments from Jim Holland and other people with the IRS is that they try to look at it on a more explicit basis and see if they can come up with the same numbers that you're coming up with on an implicit basis as a way of judging whether it's reasonable to use a lower interest rate and no salary scale.

MS. DUNSTAN: So, they might actually put a salary scale in there and combine . . . .

MR. BRYSON: Yes. Now, I have no personal experience. That's just hearsay.

MS. DUNSTAN: I guess a further editorial comment to my comment before about the retirement age is that if they're not really in favor of retirement ages under 65, perhaps they should look to all of the public plans out there that permit early retirement. An example would be the military plan, for example, where people retire at very early ages and go on to second careers. I think we have a conceptual problem here that needs to be addressed.

MR. BRYSON: Well, I think you bring up a real good point, and that's that while they're targeting small plans right now, this is not necessarily just a small plan issue, and your mentioning the military retirement systems brings to mind the fact that I got something from the American Society of Pension Actuaries (ASPA) in which they had asked the actuaries doing the military plans what their assumptions were during 1987, and apparently they used an interest assumption of 6.5%. Krishnamurthy?

MR. S. KRISHNAMURTHY: I've had several plans audited but very few plans which have been audited after the November directive about 8%. I received just one case where they made calculations on their computer program which matched mine and then another based on 8%, retirement age 65 and asked me to comment, and I said, "Well, I just don't agree with you, and, actually, these are what the plan calls for, and these are my best assumptions, and I stick to the numbers which I've calculated, and that's where it stands, and we'll take it when IRS replies." Then there are another five or six audits which are going, and I've given my certifications as to what my interest rate and retirement age are. But prior to the November memo, there were at least two cases where we were able to negotiate with IRS. They said, "Well, we won't allow retirement age 55. How about 59? Will you accept that?" It was sort of a bargaining process, and they were happy if they got 30% of what they were looking for, saying, "Well, we have a negotiated settlement," and the matter ended there. And one other case where I said, "Well, IRS, you are correct, and I take back everything that I did," and got a zero deduction from some 40,000 or something like that. And a third case where I said, "Look, I'll use your calculations to show that my assumptions are reasonable," and they didn't get back to me. So, I think prior to November, they were prepared to be flexible, and they were after a negotiated settlement, and I still don't know what's going to happen in this 8%, but at least I'm going to take a firm stand on two things. One is if I have used 5%, I'll say, "Hey, I made a mistake." Come on. Let's go on to 7% and try to settle it, but on the retirement age I'm not going to give an inch. I'm going to say this is what we designed the plan for, and I'm going to stick to it, and I don't care what the IRS

says, and I'll go to the tax court. That's my decision on that, and I'll get a couple of lawyers to comment. So, that's not an IRS position. I'm prepared to negotiate on a preretirement interest basis. But I want to come back to one thing. After all, this is a deduction issue, and I grant the IRS the legitimate right to come and question and ask us, "Did you use your best judgment or do you want to reconsider your judgment?" Those are legitimate questions, and I will not fight the IRS on those legitimate questions.

And finally, we, as actuaries, know that there is a lunatic fringe who have abused their situation, and anything that we can do to support IRS is welcome. So, while we are talking about IRS, I think we need to be guarded and say we fully support the IRS program. We don't agree to 8% and 65. We don't agree that you can go back to 1984 and 1985, do all these things. The Tax Reform Act (TRA) 1986 mandates, and Omnibus Budget Reconciliation Act (OBRA) 1987 full funding limits are all very good things for the DB plan. In spite of the fact that deductions have gone down, they are very sensible. These should have been brought out along with ERISA, but the problem is that having had bad habits, all of us have had bad habits, when we tried to change the whole thing, there is a resistance, and that's what we are seeing with the last year. So, I think that we ought to tell IRS, "Well, don't go very rigid on the 8%, but go after the guys who projected the 415. Go after the guys who have funded on a unit credit basis. You'll get the money there. Don't go after the guys who just used 7% and 55 and 60. You're not going to get too much money out of that."

MR. BRYSON: I love it.

MR. THOMAS E. CUMMINS: Given your client caves into this pressure, are you obligated to go back and change your Schedule B? In the ones that I'm involved in, they've audited 1986, 1987. In response to his question about the money being there, yeah, this money may be there, but they always want it. Even though I get maybe the next year, they're now wanting to tack on that 10% excise tax for extra funding and all that stuff, but given that the client does cave in on that, do I have to go back and change all my Schedule Bs? One particular case I've got, the guy hasn't made but 1% over the last five years; we haven't even made the funding assumptions, and they want me to go to eight?

MR. BRYSON: If the plan is still in existence, I think you have to be very careful in your considerations about what you are going to do. In my particular case these were the last years of the plan. So, that's not an issue that I have confronted yet. But I think it's very important for us to see the fact that regardless of whether the IRS agrees or disagrees with the basis upon which the deduction is taken, we still have an obligation under ERISA to the plan participants to use the assumptions that we feel are in compliance with the ERISA requirements. I am not prepared to say that just because we may have negotiated a settlement or lost in tax court with the IRS that my best estimates have now changed as a result of that. Now, the IRS does not need another enrolled actuary certification to change the results of a given valuation or deduction. I don't think they even need it to change entries to the minimum funding standards, but, of course, they're only dealing with one year, and the question is, well, what do you do with the subsequent years, and what do you do about the Schedule Bs that have been prepared in the interim years? Not the ones that had been audited but the ones since

then that haven't been reviewed yet but have still been signed, and so they have funding standard account credit balances that don't match with the IRS's calculations. I don't have an answer. What do you think?

MR. CUMMINS: I don't know. I really would not like to go through and do it, but they're actually doing all three years of mine in one fell swoop.

MS. WIANT: You said your plan has an actual return of 1%?

MR. CUMMINS: Yes.

MR. BRYSON: And they're still not accepting less than an 8% interest rate?

MR. CUMMINS: The agent says, "my hands are tied."

MR. BRYSON: Those are the words they used with me.

MS. WIANT: You need to get them to go to Washington. Another case I had, when I calculated the return it seemed to be five point something or other, and when they calculated it they came up with 3.7. My assumed rate was 5%, and they said ok.

MR. CUMMINS: Well, this guy actually computed it. But he didn't actually compute it over the four year period in which the plan's been in effect, he just computed one every year and then averaged them up, but basically he didn't even use the one that is on Schedule B. He took the interest income and divided it by the assets at the beginning of the year, which makes you have tremendous assets especially if the guy puts his money in on January 2 every year for the forthcoming year. He always funds in advance. His first call is, "I'm going to put in x number of bucks come January. Is that going to be enough?" So this guy gets a tremendous amount of interest return.

MR. SHORT: One aspect of the negotiating -- at the Enrolled Actuaries meetings, Holland said basically that the people in the field do not have the flexibility to make decisions. He didn't say it as explicitly as I'm going to say it, but he certainly implied that he thinks that you all are smarter than his agents in the field, and he's not going to allow those individuals in the field to make decisions for you all to come up with creative arguments, whether they're right or wrong, and that anyone in the field who wants to accept something less than the 65 and 8%, has to call Washington and explain what the argument is. There are four actuaries there that can make a decision to accept it. So, you're going to have a tough time, I think, negotiating a settlement, however reasonable that might be, and that is because of the new letters. Previously, you probably could negotiate, but you'll have a harder time now. And the second point is on this timing question. They are very much hung up on the fact that each tax year is a separate year in and of itself and that you are supposed to calculate the correct tax for that year. The fact that it is just a timing question, that if you don't give them the deduction in this year, they're going to get it next year, or the plan terminated the next year, and you're going to affect the reversion amounts or whatever--those arguments are not at all persuasive, at least in Washington, and you won't win on those arguments, generally. You might get lucky in the field, and it does seem that notwithstanding Holland's

statement that you have to go to Washington and get arguments accepted, some people will be reasonable in the field, and, you know, if you can find that right person, good luck. I think in Dallas there are one or two people that might be like that.

MS. WIANT: Yes, but it varies a lot.

MR. SHORT: Yes, a great deal. And it partially depends on the competence. I think the people that are better and more able to make decisions and understand the process are willing to be a little more reasonable. The people that are less competent go by the rigid rules and won't go out on a line at all.

MS. WIANT: It depends what group they're in, too, and who the manager is.

MR. ROBERT B. LIKINS: I have two questions, and it's a question of all the panelists, really. The first question is . . . Now that we're being audited on the 8% assumption and age 65 for the 1986-87, etc., plan years, is that encouraging you in the Schedule Bs that you're doing these days to change your assumptions for the ones you're doing now to 8% and 65? That's one question. The second question is really quite a bit different from that. Do your clients pay you an additional fee to argue through with the IRS these audit procedures or was that part of the original fee they paid you some years ago and you already earned?

MR. BRYSON: I'm sorry. We are not permitted to discuss fees in these sessions. That would violate the Society's antitrust principles.

MR. LIKINS: That's fine. The first question, then, on the 8% and 65?

MR. BRYSON: Well, I think that it's making us take a fresh look at the standards. After all, I think it would be unprofessional of us to blithely go ahead with the same things we've been doing without considering the risks that we now expect may come down the pike and without discussing those with our clients. However, it's still my judgment as the enrolled actuary what the best assumptions are. It's not up to the taxpayer to decide what interest rate should be used or what assumed retirement age should be used. So, what I do is to look at the experience of the plan and see if by any definition it's reasonably related to the actuarial interest rate that I'm using. As far as the assumed retirement age is concerned, it's still my firm belief that I should be using the normal retirement age in the plan because that was the way the plan was designed. So what I'm doing is giving my clients an opportunity to amend their plans, to change the normal retirement age under the plan, and if they want to do that and use a different retirement age, then that's what we'll use. I haven't had a single one tell me to change the retirement age yet. They've all wanted to go ahead and stick with the earlier retirement ages that they have in the plan. Anybody else want to comment up here?

MR. BOLIN: I think I would agree with practically everything that he has said. It does call for a fresh look. Of course one of the problems is we don't seem to have those new plans that we used to have. So, I don't think there's any question. It does call for some fine tuning, at least to let the client know what they're up against and what risks they would be involved in.

MR. SHORT: The other aspect of that, this whole 8% and 65 is really the result of one case, and it's unfortunate. The Mirza case did have bad facts. I mean, as the gentleman said, there certainly are a number of actuaries who took very aggressive positions on returns and got people some huge deductions, and, you know, they find that case, and they go after it, and they win, and then they use that to go after plans that probably took more reasonable approaches, and so there's certainly good arguments that it doesn't have to be 8% and 65. But you're going to have a hard time dealing with the IRS, and it's difficult for your clients to have sort of the fortitude to pursue it through. I mean it costs money for the lawyers or the actuaries that are going to fight it, and in a lot of cases, the economical thing to do is just concede, and that's an unfortunate situation. That may be what prevents them from going after the big plans. If there's a big plan and there's enough money at stake, someone might take it on. That's why the small plans are easy targets, because there's just not enough money at stake in any individual situation to really fight it.

DR. LESLIE W.G. TUTT: Perhaps I might take this opportunity of referring to some practice in that country which may be of some general interest. Mention has been made here of the retirement ages, and, as you may or may not know, recently retirement age has been modified under schemes in Great Britain. It is now permissible to take a full pension at age 50, subject to a completion of 20 years' service. In that connection you probably also appreciate that we have a government which is led by a person of some eminence, and as you also probably know, is not particular enamored by "hide-bound" conventions. I'm also prompted to speak because reference has been made to entrepreneurial types' application of prudent man rules and termination and distribution of assets. May I say that small schemes in Great Britain can apply to one man schemes, schemes for two or three key employees or for small groups of schemes, and those schemes are normally insured, and they normally operate on the money purchase principle, but what I really want to refer to are small self-administered schemes which have some special characteristics. These schemes have arisen since 1973 when the Finance Act of that year permitted controlling directors to become members of occupational schemes. They weren't allowed in the occupational schemes previous to that date, but since 1973, controlling directors have been permitted into schemes, and to keep these small, self-administered schemes in perspective, I would just mention that currently there are some 20,000 of them in existence, and the assets in respect to them amount to approximately 3 billion pounds. They are established principally by small entrepreneurial companies, and membership consists wholly and often exclusively of shareholding directors. Clearly by their nature such schemes have their own characteristics and so much so that authority decrees that they can't be treated in the same way as either the self-administered schemes relating to large numbers of rank-and-file employees or as insured schemes. That's whilst in the revenue practice applies to them. There are some special considerations. I would mention that these schemes are set up under trust, and the norm is for the scheme member also to be a trustee of the scheme and the shareholding director of the company, and it is to be added that as a result of the Financial Services Act, 1986, regarding the carrying on of a vestment business trustee, it is now virtually mandatory for all the scheme members to be trustees of the scheme. A further feature is that trustees must also include a pensioner trustee, that is, a person who is known by the superannuations fund office as having practical experience in pension scheme matters, and the role of this pensioner trustee is to assure that the scheme is not

wound up and the funds distributed amongst the members of the scheme. He can block such a process. As regards funding, these small schemes are usually money purchase, although contributions may be framed to achieve a final remuneration target. Actuarial reports have to be submitted at intervals not more than three years, and the supervisory authority examines with great care the assumptions adopted in funding the scheme. I would add that the Services Faud Office (SFO) would question the payment of special contributions not justified by the recommendation of the actuary and the liabilities of the scheme.

The investment aspect is, in fact, of some especial interest for there has been the understanding that there is no outright objection to loans out of the scheme, funds, to the employer on commercially reasonable terms which, boldly speaking, do not exceed 50% of the fund of the scheme. Fifty percent of the fund of the scheme can be loaned back to the employer. Now, this has aroused some recent controversy because occupation schemes in general in Great Britain have been restricted in their self-investment to around 5% or 10% of their fund, but there has been some flexibility in this, and recently it has been decided that strictly . . . desirable and strictly to adhere to self-investment not exceeding 5% of the funds, and it was proposed this should apply also to self-administered pension schemes.

So, that was a major alteration. Up until then, 50% of the fund could be loaned back to the employer, and now they are proposing that only 5% can be loaned back to the employer. Well, as result of considerable pressure, this 5% limit that has been decided is not to apply to these small, self-administered schemes so that small, self-administered schemes can still have loaned back to them 50% of the fund which is, of course, a major factor. This 50% is contingent upon all members of the scheme being trustees, and each member of the scheme has to be a 20% director, and each trustee has to have a vote. I just put these points to you because it does seem to me that these schemes have special features, and I do wonder whether you have anything similar in this country for these entrepreneurial types who are shareholding directors and so on. I just ask whether you have those sort of schemes here.

MR. BRYSON: I trust that the term "scheme" in Great Britain does not have the same connotation that it has here in the United States. The general rules regarding the operation of entrepreneurial qualified plans in the United States are fairly close to those that apply to any size plan except that there are certain regulations under the Department of Labor which only apply to employee benefit plans, and if a plan does not cover employees, if it only covers owners, then they're exempt from those rules. There are, for instance, certain rules for disclosure to employees that are obviously not required, and certain bonding rules that aren't required. I don't know if the prudent man rules are waived for plans that don't cover employees or not. Certainly, the prohibited transaction rules, for instance, prohibit loans of the trust back to the employer; those are not allowed for any ERISA-covered plan whether it's qualified or unqualified.

Because of the shortness of the time, I want to divert momentarily just to wrap things up a little bit. You have the outline which covers some of the basic IRS positions on the issues. These are basically what I copied down from a transcript of the tape at the enrolled actuaries' meeting, with the exception of Item H, which is what the field agent

that I was dealing with told me specifically. That was that if your five-year average is under 8%, you can use it, otherwise you can't. He also said that the interest assumption guideline is currently only being applied to the question of deductions, not minimum funding standards. So, in other words, if you had an average rate of return of 2% over a five-year period, that you would not be forced to use that in order to calculate minimum funding standards. Now, like I said earlier, that's today. I don't know what they'll say tomorrow, let alone three years from now when they audit the plans that we're working on today.