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UPDATE ON THE IRS AUDIT PROGRAM AND THE AUDIT GUIDELINES

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This session will provide an update on the IRS small-plan audit program. Areas to be addressed include:

- The Tax Court trial scheduled for January 1992
- Does the "resolutions program" work?
- Are the audit guidelines useable?
- Differentiating between actuarial malpractice and difference of opinion

MR. JAMES E. TURPIN: I'm pleased to have Fred Reish with the firm Reish and Luftman in Los Angeles. Mr. Reish is probably one of the foremost legal authorities on the small-plan actuarial audit program. We also have Steve Matthews of Matthews, Malone & Associates in Phoenix. Steve has the honor, or the dubious honor, I guess, of having been the plan actuary for roughly half of the Phoenix cases that we'll be talking about. He has a lot of eminent knowledge of how they work.

As I said, we're going to be talking about an update on the small-plan actuarial audit program. Specifically, how we've evolved and where we expect to go in the future. Two hearings were held back to back in Washington in January: the Vinson and Elkins case, which is a Houston law firm, as well as Wachtell Lipton. And then, most recently in February, there were hearings in Phoenix in the Tax Court dealing with eight small-plan cases. At this time, I'd like to turn the session over to Fred Reish. He'll give you a little background, and then we'll have Steve talk about some of the more practical aspects of what he's dealt with in the small-plan audit. Then we'll come back to Fred for some other points regarding how to deal with the IRS in this area, not only auditing of the small plan from an actuarial standpoint but some of the other things that are coming about including the new closing agreement program (CAP).

MR. C. FREDERICK REISH: Because I'm a lawyer, I see the world a little differently than you. Steve sympathizes and empathizes with you so you'll be hearing part of the world as seen through the eyes of a lawyer and partly as seen through the eyes of an actuary.

I want you to imagine you have signed a Schedule B on a 5500. That Schedule B is going to be audited. You assumed an interest rate and you assumed a retirement age or a set of retirement ages. To do that, you must have gone through some thinking process or some analysis. I realize how it varies from small plans to larger plans; nonetheless, there's a certain procedural analysis that you need to go through responsibly to have selected the assumptions that you selected. The audit goes from the Employee Plans Division to Appeals to the Tax Court. You're now on the stand

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being examined in the Tax Court. Let's take in a very small, simple case. Assume I'm the IRS attorney, and I'm about to ask you about why you assumed 55 as the retirement age or why you assumed a 5%, 6% or 7% interest rate assumption. You have to justify it. Alternatively, why did you use that old mortality table? Why didn't you use a current mortality table? Why did you use 6.5%? Why didn't you use 8% or 8.5%? Let's assume it's a minimum funding case because minimum funding is one of the targeted areas that audits are being directed at now.

We have maximum contribution and minimum funding. You can be on the stand for either one of those. And if we take the IRS's perspective of the issue, there's one correct interest rate, that's 8%, and there's one correct retirement age and that's 65 and if you don't use those, you're in trouble. Now we all realize that that's going to be modified some through the court decision, but that's what you're facing; Steve has been through that. Steve has been on the stand, he's been asked the questions that I've asked you to imagine that you're now being asked, and I'd like for you to be able to do it without introduction. I'd like for you to be able to see the world through Steve's eyes to get a better picture of what's going on for the actuary now and in the future. Steve?

MR STEVEN R. MATTHEWS: Well, after those questions I was going to sit down and try to give those answers. I sat down for four or five hours in front of Judge Clapp, that was long enough, it's time for me to stand.

You know there were many stories going around, and I want you to kind of follow me through this train of thought. I'm going to take you back to before May 1990 when we first sat down with Judge Clapp, and got a glimpse of what our responsibility would be with this whole audit project.

We got along well with the appeals officers in Phoenix. We got along well with the agents in Phoenix. They recognized right up front that they were just carrying out orders. They had been given certain responsibilities and they would audit these files, and regardless of what they found and regardless of what personally they felt was going on, they would simply link up point A with point B and issue a report. And, there was little that we could do to convince them to do the contrary. Now even as we got to appeals, there was a situation where appeals officers were used to adjudicating situations; they wanted to work things out but they were bound by certain limitations. There were bright lines that had been set for them. Once they met those bright lines, any further negotiations with them were meaningless. They could give you the best offer, they could give it to you right up front and make the meeting short or they could drag it out for a week or two, but the bottom line is you get to that bright line and your negotiations with the appeals officer are over.

In May 1990, we met an interesting gentleman, a judge from Tax Court by the name of Judge Clapp. He came to Phoenix in May and he held a hearing with us. In that session, he made it very, very clear that he was going to take all of these Tax Court cases. If any taxpayer went through the administrative process and ended up in Tax Court, he was going to take that particular taxpayer under his jurisdiction and he was going to look at the issues that had been brought up to this actuarial audit project. He was going to set some bright lines, and he was depending upon those taxpayers, those actuaries, those representatives that existed in Phoenix at the time that had

been associated with these cases to help him gain the knowledge and the understanding of what it took to sit down and make these actuarial assumptions. Whose responsibility was it, what guidelines did we follow, what criteria was useful for us in setting these assumptions? He impressed upon us right away that he wanted to make this very simplistic. He did not want to go through this same explanation five times or 15 times or 18,000 times. He was going to let us listen to perhaps one or two cases and from that, he was going to draw his conclusions and issue his opinions.

We felt that we were representing not only ourselves as certifying actuaries on the Schedule B, but we were representing our clients. Our clients were looking at us very carefully to see how we reacted to some of the suggestions that the IRS is now making. We also felt that we were representing our profession. I don't think that anyone in this room who has ever signed a Schedule B has not had to worry about whether or not it would ever be challenged on some of the positions that they've taken. The IRS was doing this in a massive way. They were not just challenging some sun-baked actuaries out in Phoenix about some unique interest assumption that was hardly ever heard of throughout the country. These were common actuarial practices, and we took it very personally for ourselves and also for our profession.

We also knew there were some large law firms that would be interested in presenting their case, and we also found out very early on that they did not want us messing up the project. They wanted the first crack at Judge Clapp, they wanted to be able to present their case. They weren't necessarily interested in having us tag along, they wanted us to stand on our own merits and quite frankly, the IRS wanted the Phoenix taxpayers first. They didn't want to have to go through the Vinson & Elkins and Wachtell Liptons if they could avoid it. They would have settled with them; they would have gone after them after the fact, but they would have liked to have had the small taxpayers in Phoenix put forth their case and perhaps taint the judge's opinion about how these pension plan actuarial assumptions were set.

The judge impressed us with the fact that he felt that this was a case that would be resolved by the experts. He wanted experts to come to Phoenix to present the facts, and he felt that with the proper explanations, he could make a wise and conscientious decision about how these 18,000 or 12,000 cases should be handled. He knew there would be certain fact actuaries who would definitely stand up and consistently say that the actuarial assumptions that they used were reasonable. They felt that he had to have some input from the clients as to how they felt the actuaries had handled themselves in setting these assumptions.

So we looked around the country. We wanted to call upon the best actuarial talent that we could find. Now there's a lot of that available to us, but we were looking for three criteria. We wanted actuaries who were good in theory, who had tremendous communication skills because we were going through an education process with the courts, and perhaps who had some experience. In retrospect, we feel like we found those actuaries, we feel like they did an outstanding, credible job for themselves and for us as professionals in front of the courts.

We also wanted to look at some other supporting experts, perhaps some economists that might feel that interest rates were going the way that actuaries in 1986 or 1987

felt interest rates were going. Perhaps they were representatives with the Pension Benefit Guaranty Corporation who felt that they were at odds with some of the recommendations that were now being made by the IRS through this audit project. Maybe the same thing could be found with the Department of Labor, maybe even some old IRS staff was lingering around that might want to come to the aid of certain actuaries in Phoenix. The judge made another comment; he said he didn't want a parade of actuaries or experts coming across the bench. There was one other limitation in that we had no way to pay for all those expensive experts. So we had to refine the process and come up with what we felt were the best experts to present to the courts.

The next obstacle that we had to overcome is what cases would be selected. When we sat down with Judge Clapp in May 1990, there were somewhere between 20-25 cases already in Tax Court. About 15-18 of those cases were actually Phoenix cases, others had snuck in from various parts of the country. We began to interview some of the taxpayer representatives. We wanted to find out what was unique about their plans. Were there any problems? Were there any concerns? What was the mentality of the taxpayers? Did they want to go forward with something like this? As we began to go through those conversations, we limited the number of cases we could come up with that were viable cases for the judge to accept or to review, to five cases. So, we presented those to the judge. At the same time, we found out the district counsel was also looking for some additional cases, and they came up with five more cases. These cases were not part of that original two dozen bracket or aggregation of cases at which we were looking. They had come up with five somewhat unique cases all with similar characteristics that they felt gave them a step up on perhaps some of the points that they were trying to make to Judge Clapp.

Now I want you to think for a moment about what arguments we want to present to the Tax Courts. We came up with a fairly lengthy list, but in order for you to really participate in this, I want you to listen to some of the concepts and ideas, that were shared with us as we prepared for Tax Court. There was an attorney in Phoenix who kept saying, "It's in the spirit of ERISA; the things that we did when we funded these plans were in the spirit of ERISA." I got tired of hearing that, but I thought well, let's look at that a little bit deeper. Was it the intent of Congress to improve benefit security? Didn't ERISA stand for Retirement Income Security, and didn't that come across in some of the themes that we heard talked about as Congress prepared themselves for this new change? Were there regulations or guidelines out there that were perhaps following that same characteristic theme? In fact, weren't there some court cases that were mandating that benefit security be of the uttermost importance to benefit consultants and to actuaries and to pension plan administrators? To whom does the actuary serve; to whom does the actuary owe allegiance? Is it to the participants of the plan, is it to the plan's sponsor, or is it to the IRS? Is it independent of all those agencies? Those were questions that we wanted to bring out or try and highlight in the expert reports as we began to prepare ourselves for this February due date with Judge Clapp.

Another frequent comment was, "My client received a determination letter." Stop, that's it. How do we see the determination letter? There's nothing the IRS can do. In fact, when we met with Judge Clapp in May 1990, there was a taxpayer out of Tucson using this as his whole argument. He was going to walk in and visit with

Judge Clapp and say, "Judge, here's my determination letter. It talks about the normal retirement age, it talks about actuarial equivalence, there's nothing left to talk about."

We knew that many plans had adopted normal retirement ages earlier than 65. We knew that all plans, at least those that were providing lump sums, were required to have some kind of actuarial equivalence definition. We knew the IRS knew what tendencies existed in the marketplace, and we wanted again to bring that out to the judge. Let him be aware of the fact that there were specific reasons why clients were looking for these earlier retirement ages. There were specific reasons why actuaries were calling for 5% and 6% interest rates. We didn't want to peg our whole argument on that particular issue.

One of the other comments that we heard or read in some of the communication we saw between the actuary and client was, "As the actuary, I prepared contributions based on a 5%, 6%, and a 7% interest rate. Now the client chose the 5% contribution. Now as the actuary, I believe all three are correct." That was not a suitable argument. Section 412(c) says you have to give your best estimate. Now if your best estimate is 7%, then that's all the courts have to allow. If your best estimate is 6%, that's what the certification calls for. And if your best estimate is 5%, then that should be your best estimate. Small plans have a history of earning 2-3% less than large plans. The judge is going to want to hear why. Why do small plans tend to achieve less than large plans?

To begin with, we want to define what a small plan is. Now I've been to six or seven sessions at this meeting, and I've heard little in the way of consistency as to what a small plan is. I've heard small plans are less than 10,000 lives. That is not a small plan to me. I've heard small plans are less than five lives. Now we're getting into the general area that I consider to be a small plan. I've heard small plans described as plans with less than $10 million or less than $5 million or $1 million in assets. We took it from a different vantage point. We said any plan controlled by one or two principals is a small plan. I don't care if you have $15, $25 or $5 million worth of assets; when one or two principals control the outcome of that plan, we took the position it was a small plan. That somewhat frustrated the IRS when they had us on the stand because they would have liked to have pinned us down and gotten us to refine what our definition of a small plan was so that they could perhaps use that against us in other certifications or other situations of which they may have been aware.

But what makes a small plan unique? To begin with, we have emotional investors. They make emotional decisions. If the stock market drops, what do they do? They jump out of the stock market. They have perfected the old adage of buy high, sell low. Small plans are accessible to promoters. I don't mean that in a negative way, there's a lot of highly motivated salespeople that the small plans have to contend with. They're on the golf course, they're at dinner, they're surrounded by promoters, but they hear of all these concepts, these new ideas, these ways of enhancing the types of returns that they can get, and they're vulnerable to it. They have no fixed investment policy. They have volatile liabilities: death, disability, plant shutdowns, and terminations which all have a dramatic impact on the liabilities for their plan. They have no risk pooling, there's no law of large numbers, and they have high

expenses relative to the number of participants. Those were the type of points that we were trying to put across to the judge in our reports and in the testimony that we offered in the courtroom.

Here's another statement that we heard. The attorney drafting the plan advised the actuary that 5% and age 55 was reasonable for this client. That really happened. We didn't want to leave that impression upon the judge. We did studies showing that actuarial organizations had indicated that in 1986, 2,500 plans had been reviewed and most of those plans were in the Phoenix area, and the average rate of return was 5.6%. Now does that necessarily justify my assumption? Not necessarily. It confirms the fact that your assumption was reasonable, it adds support for your position, but that's history.

What you were doing in 1986 or 1987 was sitting down and looking to the future based on your experience and expectations for that plan and coming up with your best estimate. An actuary is unable to predict exactly what the experience of the plan will be. Once the last dollar of benefit is distributed, the actuarial experience can be compared to the actual experience. In the interim the actuary should be conservative. Again we found that argument would be unacceptable to the judge. The judge wanted us to understand why the actuary was taking the position. It couldn't be left to a situation where we'll look at the facts and circumstances after all of the participants have been paid out. We have to make a decision now. The actuarial audit guidelines, comments by Congress, and existing revenue rulings point to a range of reasonableness. That range has to be determined over three to five years of elapsed time. We know of confidence intervals such as 4% that were announced at the EA meeting in 1986, and we can adjust for nonrecurring experience. Again it doesn't answer the question. It tells us that we have some latitude, it tells us that we have the ability to use some discretion in choosing our assumptions, but our best estimate has to be reflected on that Schedule B.

Actuarial assumptions are corrected annually by the actuarial funding method. Thus, the choice of assumption isn't really that critical. It's a self-correcting process. Again, that's not what the Schedule B asks us to do. We're supposed to come up with our best estimate, and we can't stray from that calling. So of course, you give deference to the actuary unless it can be shown that the actuary was acting in an arbitrary or a capricious manner. We've seen decisions in our circuit, such as the British Motor Car, where those positions had been taken by the court. It was not something that we could rely upon in this situation. We had to come up with some solid proof to support how we obtained our particular set of assumptions.

Now the list goes on but before you make your decision, let me read to you the opening statement that was offered by the IRS in the Phoenix case. I won't try and read all of it, it goes on for 12-15 pages, but I'll pick out what I think are important paragraphs or thoughts. This is the IRS District Counsel now speaking:

> What you will see is a group of actuaries who ignored the realities of the marketplace and ignored reasonable expectation of future returns. Instead, they used a low interest rate to increase the contributions their clients could make. And since the Service has traditionally not

> conducted audits of the type done in these cases, apparently the actuaries did not think they would ever be questioned about their assumptions, and you'll see, Judge, that they are now scrambling to justify what they did. They claim they relied on pronouncements that are not on point such as revenue rulings dealing with qualification matters, the provisions of the Internal Revenue manual, and even a letter written by an official to a taxpayer in 1977. The petitioners have also claimed that neither the Service or apparently even this court should be able to question the actuary's judgment. But it seems incredible to respond and that Congress would have intended to delegate the determination of tax liabilities to enrolled actuaries. Finally, the actuaries justify their use of the 5% interest rate on the basis that everyone is doing it. Your Honor, the fact that a lot of people are doing it somehow rings improper. The petitioner's counsel has on several occasions complained that the Service has arbitrarily said 8% and age 65 for all cases. This ignores two important things, one is that petitioners have the burden of proof and if they fail to come forward with the information to meet that burden as has been the case time after time in these cases, respondent would simply disallow the deduction. Instead what was done was to substitute more reasonable assumptions. The evidence will show that assuming a 5% pre-retirement interest rate was unreasonable. All of these plans could reasonably expect to earn considerably more.

Now Charles Keating in 1985 or 1986 expected to earn more than 7% or 8%. The two dozen or so savings and loans or banks that have been shut down in Phoenix all expected to earn more than 7% but for some odd reasons, those things don't always develop.

The experts' report had to reflect some of the arguments that I've offered you, but it had to be done in a way that was cohesive, so the courts could appreciate how we got from point A to point B. So we began to do an outline of how we wanted the experts' report to read. In general, we wanted the courts to understand what a defined-benefit plan was, how it operated, what its significance was, and how it differed from a profit-sharing or money-purchase plan or a defined-contribution plan. We wanted to set certain reasonable actuarial standards for meeting the assumptions requirements that we were calling for. We wanted to have each assumption meet a three-prong test. It had to reflect the actuary's personal judgment, the judgment of his peers, and any regulatory or legal guidance. So each assumption that we went through with the courts was put up to that three-part test. From that, we developed reasonable investment returns.

In some of the workup that Ken Klingler did in his expert report, he started with a long-term rate, and then he made certain adjustments for contribution timing, for a fixed-funding period, for investment fees, for plan provisions, and ultimately he worked down that long-term interest rate to a rate that would be deemed reasonable as a starting point for an actuary to choose his particular assumption. That range turned out to be 3.8-6.4%. Now if an actuary was outside of that range, he would be able to justify using a 6.5% or 7% rate for other reasons beyond what Ken had covered in his report, but that was a starting point for an actuary to begin looking at

what kind of interest rates would be reasonable. In his report, he developed reasonable arguments for the retirement age, mortality tables, and then we went to the definition of what it means to be reasonable in the aggregate. From that we took those standards, and Ken applied those criteria to the eight cases that were in front of the courts, and he computed the contributions for each of the eight plans. Now as it turned out, all eight cases had adopted reasonable assumptions based on the criteria that Ken Klingler's report called for. There were three cases that ended up with different deductions due to certain mechanical or data adjustments.

It was important to us that, as the expert reports were prepared, they stand on their own feet. We did not want to have the experts portrayed as hired guns who were simply coming to Phoenix to confirm the positions that were taken by the actuaries. If there were adjustments to be made, if there were discrepancies, if there were differences, then those differences had to come out in the experts' reports.

Ken Klingler was with The Wyatt Company. Dick Joss was one of the experts for the Vinson and Elkins case, and he did a superb job. If it were not for Dick Joss, Ken Klingler, and the support of The Wyatt Company, what we tried to accomplish in Phoenix would have never gotten off the ground. So I thank The Wyatt company and I thank Dick Joss and Ken Klingler for all of the effort. They did a yeoman's task.

By comparison, we found that there was a case that was headed to federal district court. This case dealt only with the interest rate. The taxpayer was going to support the 5% interest rate or the 5.5% interest rate that was used based on a report. Everything that was in the report may have been more than adequate, but we felt we only had one chance and we had to bring as many arguments to the courts as we possibly could with as much support from as many different points of view as we could develop. So all of the work that you see going into Ken Klingler's report was the culmination of all these thoughts, all of these conversations that took place over the last two years.

Right now, the courts have accepted the taxpayer's position. When I say accepted, they didn't throw us out of Tax Court, they listened to us. Judge Clapp was very attentive. We are now in the process of putting together our briefs. Our briefs are due by the middle of May. We expect or fully expect there will be amicus briefs submitted by other interested parties. Judge Clapp has told us that in 1992, we will see a decision out of the courts. Now it is unique for the Tax Courts to be that responsive to these types of issues.

Those who fail to learn from history are doomed to make the same mistakes. In other words, I want you to know that the IRS learned a great deal about how pension plans operate when they came to Phoenix. Some of it we now see on questions that are being asked on the 5500 Schedule B like when is the last time you valued assets? I don't know how many of your clients have invested in limited partnerships, or collectibles, or pieces of artwork for which you can't easily determine the market values by opening up *The Wall Street Journal*, but many of our clients have those types of investments. One of the issues that was raised by the IRS was the 1,000 hours of service. We had to justify, in certain situations, how an individual could provide 1,000 hours of service to the corporation. They had other interests,

perhaps they were a spouse, but we had to come up with support that was sufficient for the courts to convince them that the 1,000-hour requirement had been met. Issues such as plan investments, plan amendments, prohibited transactions, all popped up and had to be dealt with as part of the cleansing process as we went to court.

MR. TURPIN: I want to make a couple of quick comments here before we turn this back over to Fred. I'd like to mention that the Pension Committee of the American Academy of Actuaries is doing a summary of the testimony and the reports of all the experts in all three of the trials. I happen to be responsible for the initial draft of a good portion of the material. First, I received all the material from Phoenix and the *Wachtell Lipton* case. We're still waiting on the material from Vinson and Elkins. To give you an idea of the volume involved, of the two I have so far, there's 5,500 pages of material. That's the experts' report and all the transcripts from the trials. If you want a copy, a strong back and $700 will get you a long way in our office at the moment. But we expect to have that done by roughly the middle or end of May. I'm hoping it's done by the middle of May, and we'll review it and distribute it through the Pension Committee of the Academy.

One quick note, I have obviously an interest in this because we have a number of clients who are being audited, and there was a comment Fred made last night. I was talking about being the moderator for this panel. Fred said, "Nothing I have to say about the small-plan actuarial audit can be construed as moderate." And for those of you who read some of the material I published, you've recognized the fact that I'm not exactly enamored with the way the IRS has handled this. I would like to turn it now back over to Fred because he's got some comments to deal with from again the nonactuary's perspective.

MR. REISH: Well first, Steve, I don't think I've mentioned to you that I'm currently working on drafting the amicus brief for the American Society of Pension Actuaries which will be filed in the Tax Court cases, and which will focus on the role of the actuary, the concept of an enrolled actuary, and the fact that if it didn't mean something it wouldn't be there. I'll get into what it means.

As an outsider, that is, I'm not a party to any of the cases that were tried, I think I can fairly say, which Steve can't, that it appears to me that the trials went extremely well for the taxpayers. If you're advising clients on how to handle their audits or their appeals or whether or not to go to Tax Court and wait for these cases to be decided, I would feel a lot better about those trials than you might have felt six months or a year ago. The taxpayers and the expert actuaries for the taxpayers did a great job.

I was particularly interested in the building block approach at the selection of the economic assumptions. It strikes me that any actuary who is working with a plan that isn't large enough to create its own experience for purposes of creating its own separate actuarial assumptions is going to have to go through a process where you select certain, sort of, generic assumptions, and then you test those against the facts and circumstances of a particular plan and modify them accordingly. I think that is going to be the responsible practice of actuaries. If you don't do that, it's possible you're going to be second-guessed.

So I think you have to go through a process similar to what these experts did, then I think you need to test it against the circumstances at hand if you're ever going to be in a position to defend yourself against either a maximum contribution or a minimum funding case. I think you have to have it in a file somewhere; I don't think you can say you did it in your head. I think you've got to have all of your standard backup for developing your 1992 basic assumptions, and I think that's going to have to be in one set of files. Then, I think for each client, you're going to have to show how you reviewed that client's facts and circumstances, and how you either accepted or modified your standard actuarial thinking vis-à-vis that case. That may very well make the difference between being tagged with a malpractice claim or not. So the process is very important now.

We're in the unfortunate position where we've got a judge as a lawyer, a whole bunch of IRS lawyers (I think there were three sets of IRS lawyers for each of the three trials), a whole bunch of private lawyers, and few expert actuaries who are going to decide the outcome of this case. Well, the lawyers outnumbered the actuaries here so that means, per se, you're going to get a decision that doesn't make any sense because the lawyers are going to be setting actuarial assumptions, but actuaries know a lot more about it than any attorneys, but still, there's a limit. We haven't done this all our life; we don't appreciate many of the intricacies. So there are going to be some decisions coming down that are going to govern a lot of people, and this is not limited to the small-plan market. I know of at least one multiemployer plan where there's been a disallowance on the basis of actuarial assumptions. I know of a Fortune 500 company that's going through an actuarial audit right now. It's fairly widespread and it's here to stay. There are hundreds, if not thousands, of trained revenue agents now that know an actuarial assumption when they see one, and they're not going to forget it as soon as this audit program is over. So this is now a part of our lives. Forewarned should be forearmed if it's taken to heart. So from now on, it's the defensive practice of the selection of assumptions.

I've read a lot of the transcripts and the expert reports. I wish I could tell Jim that I've read all 5,500 pages so I could synopsize them for him but I haven't quite done that. I wanted to read to you one part that I thought was interesting. It gives you a little bit of insight into the judge's perspective. This is from an article that my partner, Bruce Ashton, and I will be publishing next month. By the way, I do a newsletter every six weeks for free. I mail that to about 2,000 people around the country so if anybody wants to get a copy of that newsletter, for which there is no charge, please contact me and I'll be glad to put you on the mailing list.

Okay, this is just a very brief excerpt from the trial. The introduction is the questioning of Mr. Stephen who is one of the principals. His is one of the small cases in Phoenix. He was a lawyer who did medical malpractice work. The questioning of Mr. Stephen turned to the issue of the return on plan investments. Mr. Robinson, who is one of the taxpayer's attorneys, pointed out that Mr. Stephen had invested in a real estate limited partnership that became worthless. Mr. Robinson stated, I think that kind of information confirms some of those risk concerns that all of these actuaries have been talking about all week when they say real estate is not very good. Some of these small investors not only don't earn interest, but they also lose principal -- small investors like a few large insurance companies I guess. Shortly

thereafter, Judge Clapp made the following observations regarding investments in small plans. I'm quoting out of the transcript. The Court: "Well, it seems to me that most of the actuaries so far have testified that small plans do worse than large plans for a variety of reasons including, among others, that small-plan investors aren't very smart, are inclined to do things that aren't very logical, and get a little irrational about their investments, and don't approach them from the same systematic, logical point of view that a large plan would do. Perhaps this is a good hesitation, this would back up that conclusion, but so far all we have on record is that that's a fact." So, what the judge is saying is that's all the testimony he's heard so far.

Then he says to Mr. Robinson, "Hold back that evidence about this particular investment going bad. Why don't you hold this for rebuttal, and if the respondent [that's the IRS] comes along and puts on some witnesses that say that all small-plan investors are bright, intelligent, logical people that always do the right thing and therefore should get the same kind of income that the big boys get, you can put this in as Exhibit A or 582 or whatever comes out at that point." So that's Judge Clapp.

You read parts of the transcript like that, and you can't help but feel some encouragement that the judge appreciates there are some differences between large plans and small plans. For example, when the principal of the small plan dies, there's nobody there. It's not like an untimely death in a large plan where the funding gets worked out over a period of time. When you have a torrid event in a small plan, you're stuck and that is part of the risk of funding that plan that the actuary should take into account.

Now back to the building block approach to the actuarial assumptions. You'll see that some of the factors that the expert used are ones that I didn't think of as being actuarial assumptions before I got this deep into these cases. The approaches used in small plans to develop the interest rate assumption can have a whole bunch of effective credits and debits that take into account a variety of factors that go beyond what a treasury bond makes, or even beyond, what my average rate of return will be. There are factors, some of which are economic, like when I actually deposit the money into the plan; others are noneconomic. That's the building block approach that I think is just fascinating.

It's fascinating at the court level. If you talk that way to a revenue agent who is auditing a plan, and you give him a copy of that report, it would get you absolutely nowhere; that's Tax Court talk. Down in the trenches at the audit level, the actuarial resolutions proposal level, and even the appeals level, it's much more simplistic than the high academic mount of actuarial science and tax law.

In my law firm, we're handling about 225 of these audits from around the country, so I feel like I have a pretty good view of what's going on, particularly in the Los Angeles Key District Office. Right now, the number of audits that are being conducted has bounced all over the place. The latest data is that they're conducting (they being the Employee Plans Division of the IRS) 15,133 audits.

Each audit consists of one plan year's 5500 form. They figure they're doing two 5500s per plan on the average so they say about 7,500 taxpayers are getting

audited. This is based on data that is a couple of months old now. They still have about 3,000 taxpayers to audit. Maybe you can knock 1,000 off of that. But when I say to audit, I mean audits to complete, that is, if they haven't been referred on to the Examination Division and that they haven't been given an Actuarial Resolutions Proposal. So this is still an ongoing program, and it'll be ongoing at least through the end of July at the audit level. I have yet to get a revenue agent to buy into the argument of the spirit of ERISA.

MR. MATTHEWS: We've had a difficult time with that.

MR. REISH: I even have people in the background going "ooooo." There's still no spirit of ERISA; you know it doesn't seem to work. I think that's more for the moment and the Tax Court and people who really understand all this stuff as opposed to the revenue agents and me.

For the preretirement interest rate on a new plan, you can pick any actuarial assumption you want as long as it's 8%. There is one preretirement interest rate; it's 8% unless you have experience. If you actually have experience, they will give actual average experience as a preretirement interest rate in the L.A. district. We got into little fights over how to calculate them, but that's basically what it boils down to. If you have experience at 8% or higher, you get 8%.

For postretirement under a joint-and-survivor annuity (J&S), it's 8% unless you've used a 1971 or earlier mortality table; then it's 7%. If it's single-life annuity, you use your assumption in the plan document for actuarial equivalency which, in most small plans, is 5% although it bounces around some so let's say it's 5%. In other words, if you have a single-life annuity, you can fund for the lump-sum value converting the single-life annuity to a lump sum using the 5% interest rate for actuarial equivalency as opposed to the 5% interest rate for funding. Two tricks of the trade.

If you're below the 415 limit, and if your plan document doesn't prohibit it, you should be able to convert the full value of the joint-and-survivor annuity into a lump sum using the plan's assumptions for actuarial equivalency. If you could bring that into a lump sum at or below the 415 limit, you should be able to fund for the lump sum rather than for the joint-and-survivor annuity. We've had mixed success with that, but it is, I think, a mathematical truism. I don't think there should be any argument about that. Generally, we meet with success.

The one that we've had to argue a little harder is that you ought to be able to fund for your most valuable benefit. For example, if you have a joint-and-survivor annuity that you've been funding at 5% postretirement, the IRS comes in and moves it to 8%. Your lump-sum benefit, even if you're outside the 415 limit, becomes the most valuable form of benefit. There is even a revenue ruling out there that says any idiot participant is going to select the most valuable form of benefit so you ought to be able to fund for it. Well, they fought us on that. I understand that the lump-sum benefit ought to be roughly equivalent to a joint-and-survivor annuity at 7%. So all we're really saying to them is, "Gee, we effectively have to fund for a slightly larger amount than if you pushed us to J&S at 8%."

I know I'm throwing numbers around, but what I'm saying are general truths. I think in each case you have to see how it works out. In the small-plan area, as a statement of general truth, you ought to be able to fund for the most expensive form of benefit. Even if they play around with the assumptions, and they convert the most expensive form from one form to another form, you still ought to be able to fund for whatever becomes the new most expensive form of benefit. That doesn't give you all of your deduction, but at least it reduces the flack that they're trying to take out of your deduction.

Surprisingly, in the small-plan area, I guess because the principals are up against the 415 limit such a large percentage of the time, there aren't many plans that use salary scales. That has really been too bad because we have a lot of cases where salary scales would have been very helpful in justifying the funding notwithstanding the IRS audits. Where there are a significant number of nonprincipals below the 415 limit, we argue an implicit salary scale. In the Los Angeles Key District, we get that argument; it is an argument that is received well. Around the country, it should be that the difference between an 8% preretirement interest assumption and a 5% preretirement interest assumption is simply an implicit 3% salary scale. That is being used to justify a 5% preretirement interest assumption, and it's well-received.

If you ever just want to pick one mortality table, the 1983 IAM with a three-year setback seems to be the one-size-fits-all mortality table. You ought to be able to get that. It just seems to be where the field actuaries are within the Employee Plans Division.

If you even mention the word load, expense load, mortality load, good load, bad load, yesterday's load, anything to do with load, they hate it, they can't stand it. They don't like joint-and-survivor annuities and they hate loads. They loathe loads, so stay away from them.

Normal retirement age is 65, unless of course, there is a death, and then they give you 55.

Age 65 is what they try to put you to. If you have an in-service distribution provision or a 414(k) defined-contribution account, that will justify an age-60 retirement age assumption because you have in-service distribution. If you assume an age 55 retirement, and you have an in-service distribution provision, they argue that participants are not going to take it because of the 10% excise tax. Of course, I've got real estate people pulling money out of their plans left and right at age 30. But the IRS's theory is, nobody under 59.5 would ever take money out of a plan unless they could rollover to an IRA, and if you haven't severed service, an in-service distribution provision under 59.5 can't be rolled over; therefore, we'll only accept age 60. Then we will only accept age 60 if you have a 414(k) defined-contribution account for which you can take my defined-benefit money and put it into a DC account within the plan when you reach retirement age. We can't think of any good reason why we're going to limit you to 60 except we don't want to give you 55. Now I understand in Phoenix, at least at the appeals level, and maybe at the audit level, they're doing that a little differently. Steve?

MR. MATTHEWS: Our whole relationship with the EP/EO agents is cursory at best. They have a tendency to come out and say, here's block A, here's block B. We put them together through the system and here comes the report. So we spend very little time talking to the EP/EO agents because it does us no good. They don't have the ability to make any adjustments in Phoenix. They're somewhat bound, they're mule packing what has been the position of the National Office, and they will tell us that, so it's a waste of time for us to talk to them.

When we get to the EP/EO level or beyond that level and up to the appeals level, the Appeals have been given these bright lines. Now as long as our plan provides for a lump sum (we get age 60, 7% preretirement, 5% postretirement interest with the single-life annuity), they'll waive the 6659(A) penalties, but they will not budge on 4972. If those apply, we're stuck with those results at the appeals level. They will give early retirement consideration on the interest rate. If we can show that the plan has some history and has performed less than 7% for three-to-five years before the actuary signed the certification, they'll go 6.5% or 6%, but it's so difficult sometimes to push them in that direction for just that preretirement adjustment that we often-times don't even consider that.

When it comes to those plans that have the 414(k) language, they will consistently give us age 55. We went through a long, drawn-out process to achieve that result by arguing that if you're so fixed as an agent with the IRS on the fact that these plans can do 8%, and our plans consistently call for 5% and 6% actuarial equivalent definitions, then why would a knowledgeable businessman lock his funds up and limit his growth post-55 to these actuarial equivalent increases when he could segregate his assets into a separate account and be eligible for what you deemed to be a basic rate, this 8%, that everyone's able to achieve? So after some thought and consider-ation, they said we were right. Because these clients can do no less than 8%, then it would be unreasonable to assume that if they have this language they wouldn't segregate their assets at age 55 and take advantage of this higher rate of return. They had actually looked at some calculations that show 8% growing on a single life segregated account is better than the joint-and-survivor annuity going with the 5% interest rate. So those are kind of the givens and there isn't much that we've been able to accomplish above and beyond that at the appeals level.

Normally we calm clients down so that they're willing to listen to us again, and we begin to educate them as to what this whole process is about, how they're going to go through certain administrative steps, how they'll ultimately end up with an appeals officer, how they're not forced to accept an Actuarial Resolutions Proposal (ARP) offer or the appeals officer's offer, and that they ultimately can end up waiting in line behind these other Tax Court cases. Invariably what our clients will ask us to do is to put it into some economical framework so that they understand what they're gaining and what they're losing at each step, what the changes are as they go through these different procedures. When they deal with the EP/EO agent, he will tell them, "We've disallowed your deduction, we've disallowed 70% of it, or we've disallowed 80%." They really don't understand the economic impact of that.

You know it was fascinating to sit down with some clients and find out that they could not understand why they were exposing these dollars to double taxation. I mean it was clear in their mind when they sat down in 1987 that if they weren't

going to be able to put this money into the plan that they would have taken it out as income. If the IRS is going to disallow that deduction, why are they not able to just take it as income in 1987 and avoid going back to the corporation, being taxed at the corporate level, and then being drawn out later on as earned income or additional income in 1992 or 1993? That was a major hurdle for them to overcome. But it was clear, as we began to develop the numbers, that they could see the economic impact of having this disallowed deduction take place. It would be taxed at the corporate level, and at some time taken out of the retained earnings or taken out as an additional bonus and be taxed again.

When we get to the appeals officer, it is really difficult for some of our clients to make a decision because now they know that they're going to put themselves in line. They've exhausted all of their administrative abilities to extract themselves from this program, and they really want us to give them some impression as to how well the Tax Court case went. What was Judge Clapp's reaction? What is the likelihood of winning on certain issues or perhaps losing on certain issues? And how will that impact them, what kind of plans could they take in the interim?

Since 1987, some clients have not fared that well. Some of them have actually gone through losses on their corporate tax return. So we try to look at what has happened from the last point in time that a deduction was taken with the pension plan. What's happened with that corporate tax return? We've become much more knowledgeable in the area of tax planning and understanding what happens at the corporate level then we ever anticipated. For example, after 1987, many professional corporations had to make a difficult decision. Were they going to stay with an offset corporate year or were they going to go to the calendar year? They had the ability to retain an offset corporate year, but one of the things that they would give up by doing that was that they could not carry losses to or from an election year, a year in which they had elected to stay off the calendar year-end. Well, we found out a number of clients had been advised by their accountants to stay with a September or a June year-end, and even though those corporations had experienced losses perhaps in 1988, 1989 or 1990, we would be precluded from taking those losses back to 1988 or 1987, the year in question, and recouping some of the taxes that might be owed.

The other thing we talked to our clients about is that part of what the IRS is challenging which is the timing of deductions. If they're going to disallow a deduction for 1986 or 1987 or some other year, there may be some additional deductions that will pop up in 1989, 1990 or 1991. As we go back and review the actuarial valuations that were prepared for those years, we have to adjust the assets. By adjusting those assets, we may come up with additional contributions all of which have already been funded but now can be taken as a deduction.

MR. REISH: As an example on adjusting the assets, assume the IRS in 1987 disallows $100,000 and let's say you ultimately reach an agreement on that in 1988. If the plan assets in 1988 are $500,000, you want to use $400,000 for valuation purposes. This reflects the liability to return the nondeductible contribution of $100,000 to the corporation. That changes your funding calculations for 1988 and then 1989 and then 1990 and up to date so you could have increased deductible contributions for the intervening years. We had one instance in which the IRS audited three years for a partner in a large law firm, and the three years washed out to zero.

We had a disallowance the first year, and additional deductions the second two years. The IRS, after talking with them, actually wrote the case up that way. So at that point, we put it to the Actuarial Resolutions Program, wiped out the excise taxes and penalty taxes, and it ended up being a zero tax case.

MR. MATTHEWS: One of the things we've had to acquaint the clients with is, if they're not going to accept the appeals officer's offer, and if they're going to put themselves into a situation where a 90-day letter will be issued and they'll be then sitting behind Judge Clapp's decision, then they want their CPA to file a protective claim. Then, there are some additional deductions that may become available for 1988, 1989, or 1990 even though we didn't expect to get a decision until 1993 or 1994. If we have adjustments for those intervening years, we can go back and take advantage of those deductions and reinstitute those, and perhaps use that as an offset to some of the taxes that might be owed for the 1986 or 1987 year. So we found ourselves trying to help the CPAs understand how this protective claim had to be structured, how it had to be developed. With that, we then moved on to some of the other problems.

Some of the cases that we had worked on where deductions were now being challenged had actually been terminated because of 401(a)(26) or just because of economics in years subsequent to the year in which the IRS had chosen to audit the plan. The taxpayer had decided to terminate their program and perhaps in those years, there was a reversion, and perhaps because of the reversion we paid an excise tax. What the IRS had agreed to do was to recharacterize those reversions as a disallowed deduction for a prior year. Now imagine if a disallowed reversion of $100,000 came back to the corporation in 1988 as a result of the IRS disallowing $100,000 from 1986. In most situations as that $100,000 came back to the corporation, the choice was made to pay it out as additional income for 1988. The excise tax was paid, but the corporation ends up with a zero bracket for the year. The IRS was now agreeing that if we would accept its position, it would recharacterize that reversion in 1988 as a disallowed deduction for 1986. But, having taken the income out of the corporation, we would have created this $100,000 loss on the corporate tax return in a year in which, if we hadn't elected otherwise, we could still take that loss back to offset the taxes that were owed for 1986.

The bottom line was that when we sat down with the appeals officer and he was willing to recognize the recharacterization of those dollars in 1988 and as part of the closing agreement, they would offset the taxes and they would allow us then to go to the taxpayer who would then make an interest adjustment and he could extract himself from this project by simply paying the interest that would have been owed on the disallowed deduction for 1986. Now in Arizona, we don't have the ability to carry losses back so we still ended up with some taxes to pay at the Department of Revenue level. It did give those clients who were interested in getting out of the program an opportunity to do so with fewer dollars being exchanged with the IRS.

MR. REISH: I'd like to spend a couple of minutes on ARP and then on appeals, just some very quick points and then we'll take questions. If there aren't any questions, I'm going to read at length from the trial transcript so I encourage you all to be thinking while I kill a little bit of time here.

UPDATE ON THE IRS AUDIT PROGRAM AND THE AUDIT GUIDELINES

You know the Actuarial Resolutions Proposal (ARP) came into effect July 1, 1991. It was supposed to end March 31, 1992, but it couldn't. The IRS was too far behind in their audits, particularly in the northeast, New York and the New England area, and maybe one or two other spots around the country. They've been running way behind. In Phoenix they're way ahead. They started early there and got them good, and Los Angeles was one of the areas that started early but we started under the November 1989 infamous memorandum and we're fairly far along. In any event, this program, as a whole, was not far enough along the way to end it on March 31, and there's a lot of in-fighting within the IRS. Finally, it was extended to July 31 of this year.

So far there have been 2,000 or the most recent report I've received is 2,008 ARP offers; that means 2,008 taxpayers. Some 650 of those are accepted and based on the latest data I have, it's about $17,500 per case of tax. Now this program originally was supposed to get about $880 million of revenue. Now that somehow got boiled down and publicized as $666 million, but the original number was up around $880 million. There's a good chance that the IRS won't get $66 million of this program and nothing would make me happier. I think it was misconceived and ill-executed, and if we could turn the clock back, I don't even know that it would to do it again.

The purpose of the ARP is to get a waiver on the excise taxes and the penalty taxes. It does nothing for you on an income tax level, and it does nothing to abate the running of interest on any income tax from back in 1987 or 1988, or whenever, but it does waive the excise and penalty taxes.

Most notable among those is the 4972 excise tax. If you had a plan year beginning in 1987 or later, that tax imposes a 10% excise tax on any nondeductible contribution. I have some cases where there are three years under audit beginning in 1987 and later, and that's 10% the first year, effectively 20% the second year and 30% the third year because that 10% on the first year keeps repeating itself each year until the money is taken out. So if you had $100,000, it's a $10,000 excise tax in 1987, $10,000 in 1988, and $10,000 in 1989 on the 1987 contribution. Then if you put in another $100,000 that is nondeductible in 1988, that's $10,000 on that in 1988 and $10,000 on that in 1989 and so on. It's a repeating excise tax so it pyramids on you. And in that example I just gave you, that would be $60,000 in excise taxes.

Well, it's tough to look a taxpayer in the eye and say don't accept the ARP. If you've got a lot of 4972 excise tax, you may want to accept the ARP for a reasonable way to settle a case. Some of the tax-planning ideas that Steve mentioned are very helpful. It's possible to create net operating losses and carry them back to the earned question if you have the right kind of corporation with the right fiscal year.

The 10-year write-off is very helpful if you terminate a plan and distribute it. If you terminate a plan beginning with the year following the last year in which there was a funding standard account, you can write that off at 10% per year. The IRS takes the position if you shut down the business or if you shut down the corporation anywhere along the line, you cannot accelerate it, in other words you lose it. But I've got some cases now where the IRS may be disallowing 1987. Let's say they're disallowing $200,000 in 1987 and we terminated and distributed the plan in 1988 so that 1987

was the last year that there was a funding standard account. That means we have a 10% or $20,000 phantom write off in 1988, $20,000 in 1989, $20,000 in 1990, $20,000 in 1991, and $20,000 in 1992. We could have gotten some pretty substantial tax benefits along the way by agreeing with the IRS. They have to watch the running of the statute of limitations. I mean there's some tax planing to do there, but those are some of the ideas.

This is not just a pension issue, it's also a tax issue and that's why working as a team, particularly with the accountant and a knowledgeable tax or pension attorney, if there's one involved, can be real helpful because there are nonpension solutions to some of these problems.

As a last thought on appeals, let me just give you a brief guideline that I use on deciding when and when not to go to appeals. Almost any case where the only year, or years, in question predate 1987, (that's the first day of the plan year started in 1986 or earlier), go to appeals. Why? You don't have any 4972 excise tax so you don't have that sledgehammer just hanging out there waiting to hit you upside the head but at the appeals level, they're waiving the other penalty taxes. So theoretically, unless there's a change in the rules, which I don't think there will be, is that *déjà vu* all over again? You should come out of that relatively unscathed, and you get to wait for the Phoenix trials which I think are going to be very favorable.

If you do have one or two years after (you have a year that began in 1986 and you got a year that began in 1987) but the disallowance is very small so the excise tax will be very small, I would carry that one to appeals also. If you've got a case like I described for you, you have three years with 4972 excise tax and it amounts to a lot of money. You will sweat bullets not to do something under ARP; it's a tough decision.

Now the one area where appeals seems to be much better than the Employee Plans Division is where there are good facts and circumstances arguments, where you have a good case about the person retiring. I've got a case out of Michigan where some people sold their business and as a part of the sale of the business, the two former owners were kept on in consulting agreements. A lot of times you do that to convert part of the sales price to make a deductible for the new buyers, and the business attorney just throws in a consulting agreement to support the deduction of part of the purchase price. The IRS took the position they never retired because they were kept on in these consulting agreements. Just absurd if you know anything about business law at all; that's such a standard operating procedure in the business world. They actually sold the company to unrelated third parties, paid full value. Yet the IRS is saying they never really retired. So we're taking that to appeals; that's an atrocity and I think this is an area where a pension attorney actually trained with some adversarial background could help you to evaluate the strength of your facts and circumstances argument because we do see the world a little differently. So I think that scenario for outside advice could be helpful. But we are taking about half of our cases to appeals. About half of them either were getting no changes on at the audit level and we're settling under ARP. So that should give you a good idea of what we're up to.

MR. TURPIN: Fred, facts and circumstances don't always work. We have a case that's under audit at the moment, I guess at this point it's to the appeals officer. I had an orthopedic surgeon who's legally blind and the IRS is insisting he will continue to practice medicine for another 20 years. So, as I say, logic doesn't always prevail and neither do facts and circumstances.

We have another case. The audit closed after we were able to give the IRS a copy of the person's death certificate. He was actually killed in a plane crash and he had retired before he died so it was a question of whether it's retirement or not.

MR. ETHAN E. KRA: Have you come across any situations where the IRS has refused admission to ARP, to any of the small professional corporations?

MR. REISH: There are two cases of which I'm aware. Jim and Steve will immediately step in and correct me. The first is if there's also an income tax audit going on independent of the employee plans audit. They've got a deal apparently as a part of this ARP program, the Employee Plans Division had to cut a deal with the Examination Division that they would not close out any years that the Examination Division also had under audit.

The other is, in theory at least, they're not supposed to use the ARP on cases that involve any issues other than pure actuarial assumption issues. Now, as a practical matter, they are, and I can give you some examples but I'd rather do that off the record. An example of one in which they should not use ARP, for example, would be if they find an IRC violation in connection with their audit. They're supposed to take that, write it up, throw it under the CAP program, and negotiate a price with you.

FROM THE FLOOR: Okay, because I know of one situation anecdotally. I'm not the enrolled actuary. Our firm doesn't handle the plan but . . .

MR. REISH: I've heard this before. I have a friend, right?

FROM THE FLOOR: I mean I'm not the enrolled actuary, I know about it because he may be a physician that's actually rendering medical advice, and being an actuary you hear about these situations when you're in there for medical advice.

MR. REISH: I got you.

FROM THE FLOOR: He's being refused admission to ARP, and apparently there's an issue as to the application of the 415 methods. He didn't even know that 415 existed until he was denied admission to ARP.

MR. REISH: Well, that's consistent with how the program is supposed to be . . .

MR. TURPIN: Any qualification issue?

FROM THE FLOOR: This is not an issue of payment; this is a funding issue on 415. There has been no distribution. Now I'm getting the physician's version of what he understands to have happened. The actuary funded assuming retirement at age 62

(this goes back pre-Tax Reform Act), $75,000 or whatever you'd be using at age 62. Then at age 63, let's arbitrarily say it's $80,000. He'd collect $85,000 at age 64, and then he'd collect $90,000 a year starting at age 65, so they were funding a benefit that looked at the 415 limit in effect for commencement at the given ages being payable for that age. It just bumped up until he hit 65 which I think that most of us would agree is not the way 415 works.

MR. REISH: Right.

FROM THE FLOOR: And because the funding was done on that basis, he is being denied admission to ARP on any issue.

MR. REISH: They have the right under the original ARP proposal to decline that case because it's not an actuarial assumption case, at least not as they define actuarial assumption. My experience is that where it's sort of closely related to a funding method or an actuarial assumption case and it's not too far off the charts, it looks like a mistake. In the individual districts, the revenue agents or the resolution officers are exercising some discretion on that. I don't think you can hammer them on that one because they can point right to the document and say, "We don't have to take that one, in fact, we're not supposed to," even though often they do.

MR. DONALD J. SEGAL: All your comments have been with respect to the actuarial assumptions. I understand some of the cases involve what I'll refer to as funny funding methods.

MR. MATTHEWS: There were five cases that were in Phoenix that have the unit-credit funding method.

FROM THE FLOOR: The so-called accelerated unit credit. Are we still trying to defend that funding method as being a reasonable funding method or has that been abandoned?

MR. MATTHEWS: No, we're still defending that funding method.

FROM THE FLOOR: Do you believe that Judge Clapp will be able to differentiate between the assumptions question and the funding method question?

MR. MATTHEWS: Oh, absolutely. I think that Judge Clapp had a strong dose of the interest rate, normal retirement age and mortality table arguments when he was back in Washington in January. He listened to six or seven days of testimony and read reports that had nothing to do with the funding method. When he came to Arizona, he got a refresher course in those same areas, but we spent perhaps a day or day-and-a-half just talking about funding methods, and the unit credit funding method -- how it was applied in those Phoenix cases. Again, I think the arguments were well-accepted by the judge.

MR. REISH: The expert testimony was given by an actuary by the name of Arthur Anderson on behalf of the taxpayers for the unit credit funding method, and I think it was extremely well-received. And one of the pleasant surprises is that the funding method could come out 100% clean and the actuarial assumptions only come out

90% clean or something. So the funding method was very well-supported at the trials. If some people weren't using that funding method, I don't think they need to worry that it tainted the actuarial assumptions in any way.

There were six days of trial on the actuarial assumptions. That's for each trial back east. There were six or seven days in the Vinson and Elkins case. These cases were exciting.

MR. TURPIN: Let's assume Judge Clapp does meet his deadline of rendering an opinion during calendar year 1992 (we expect it to be late in 1992). Depending on the mind-set at the Internal Revenue Service and their General Counsel's Office, if the IRS does not come out with a favorable ruling, we will likely see that being appealed with the IRS and vice versa. Obviously the taxpayers will make a decision as to whether they want to appeal. So the appeal process could take this into 1995. Is that a reasonable time frame? The Mirza case is the IRS's benchmark for most of the work they've been doing. And as a reminder, the judge accepted age 55 as the appropriate retirement age for Mirza, but that was a 1980-81 plan year that was finally denied with the Supreme Court in 1989-90. So you know this whole thing could be resolved in an eight- or nine-year period given we're looking at a 1986 plan year as one of the first plan years under the audit program. Seeing a decision made in the mid-1990s ultimately may be a possibility. I think what we're going to see, and this is one of the things the IRS is looking at, is that the collegial relationship that has existed in the past between benefit practitioners and the Employee Plans Division of the IRS is changing somewhat. The employee plans are being encouraged to be more aggressive and to be less helpful. I guess the best way to put it is to look more closely at some of these issues, because they're being encouraged, like every part of the IRS is, to raise revenues. You may find they're less forgiving of problems that you may encounter, whether it be the 415 problem that's been discussed or some of the other issues.

MR. REISH: One of the questions that comes up is, is there a malpractice liability (errors and omissions) for actuaries? There's two aspects to this: first, can or will I be sued, and second, will I win or lose? Being sued is horrible; that's bad enough in and of itself. Losing is very expensive. There are a lot of people that aren't insured. I would just encourage everybody to have errors and omissions insurance. Until you've been hit with a lawsuit and you know what it's like to live with somebody asking for $500,000 or $1 million or whatever out of your pocket, you just can't imagine what a cloud that puts over your life. Lawsuits are like gum on the bottom of your shoe; they just don't go away. They will be there five years from now; they go on and on and on, it's a miserable way to live your life if you don't have a lot of insurance protecting you. I really encourage people to have insurance.

Before this program, I contacted two of the top insurers for actuaries, and I asked if there has been any lawsuits filed under the actuarial audit program. And they told me there's been one lawsuit filed for $1.2 million so it had to be a fairly serious situation. Lawyers seem to overstate the damages whenever they can just to scare the daylights out of people. There's no doubt in my mind there will be lawsuits. And there's no doubt in my mind that a lot more actuaries are going to be sued in the 1990s than were sued in the 1980s. I see a very changing world where, to a large degree, actuaries are going to be used as a protector and enforcer of the Internal

Revenue Code and of the public good. It's a new world and those who don't adapt will suffer. If my vision of the future is right, then you understand why I'm pushing people to be covered by E&O insurance.

If a case is settled under the Actuarial Resolutions Proposal, where the excise taxes and the penalty taxes are waived, there are no meaningful damages. You can't have a lawsuit without damages. A person has to have been hurt, because if you think about the taxpayers' position, as an actuary, you said you can deduct $200,000. If the IRS says you're wrong, you are wrong. All the taxpayer pays is the amount of income taxes that they would have paid had they done it right to begin with and if you walk through my hypothetical situation, there's no real damages. Well, where does the real damage come in? What about interest? You have to pay all the interest on taxes during all those intervening years? The money was in the fund earning interest during those intervening years, so there should be a substantial offset there. Well, where are the damages? It's the 4972 excise tax, the 6659(A) penalty tax, and the 6651(A) penalty tax. If those aren't present, there aren't damages. I could give you a couple of exceptions to that but it would be off in never never land, and we don't have the time right now.

FROM THE FLOOR: How about double taxation?

MR. REISH: That would be the exception. I can explain how in most cases you could avoid the double taxation, but there are some where you just can't avoid it. There you do have real damages. The other point I wanted to make is to the extent that the lawsuits don't come out of the actuarial audit program. Everybody's heard about the Closing Agreement Program. The top people in the National Office and the Employee Plans Division have 100% wholeheartedly endorsed CAP. The CAP says if you find a disqualifying defect, you disqualify the plan in effect. You say the taxes, income, excise, penalty taxes that would be paid as a result of being taxed through to the employees, having a taxable trust and the disallowance of deduction, all gets added together and that's the IRS's starting point for negotiating. In a real disqualification situation, it would not be uncommon for that to be 50-100% of the value of the trust fund. So that's the starting point; then they negotiate from there. Well, you've got the top people at the IRS endorsing it. They've told the chiefs and assistant chiefs at the Employees Plans Division and the different Key District Offices that that's their program. Those guys have told the group managers and the group managers have told the revenue agents, and it's been endorsed 100% up and down the line. So that means that a revenue agent who wants to curry the favor of a group manager has to go out and get a CAP case now. And that means the group manager who wants to curry the favor of the chief and assistant chief of Employee Plans at the District Director's Office had better be producing some CAPs. And that means that the assistant chief and the chief who want to be well-thought-of in the National Office need to be producing some CAPs. This will be a tough environment, it's going to be very adversarial. Richard Shea, who's now in private practice, was with the treasury office during the writing of the K and the A4 regulations. Richard Shea has a favorite saying that he uses in his speeches where he says, "There are no qualified plans, there are only disqualified plans waiting to be discovered." It's complicated now and the reason we're laughing is because there is some degree of truth in that. So I just again practice a lot more defensively. That's all you can do, be alert that this is happening.