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The Small Plan Audit Program

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Abstract

From the perspective of sponsors and administrators of small defined benefit pension plans, one of the most important recent issues involving government regulation has been the IRS small plan audit program. The program was expected to raise two-thirds of a billion dollars by targeting well-funded defined benefit plans with five or less participants. The strategy was to retroactively disallow "excess" contribution and to impose penalty and excise taxes.

Not surprising, many small plan audit cases ended up in the Tax Courts and, in due course, decisions and opinions were rendered in three lead cases.[1]

The purpose of this research is to analyze these cases and their implications. The research is important because it provides insight into appropriate paradigms for the funding of private retirement plans.

Keywords: small plan audit program, actuarial assumptions, opinions of the Court.

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[1]The cases were composed of two institutional and eight noninstitutional cases. The two institutional cases were the first to be tried, and involved large successful law firm partnerships which had adopted individual defined benefit (IDB) plans for their partners. The noninstitutional cases were consolidated and tried as a group.

The Small Plan Audit Program

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Introduction

From the perspective of sponsors and administrators of small defined benefit pension plans, one of the most important recent issues involving government regulation has been the IRS small plan audit program. The program began in November, 1989, when the IRS initiated a nationwide plan to audit the actuarial assumptions of approximately 18,000 small well-funded defined benefit pension plans. It was expected to raise two-thirds of a billion dollars in additional tax revenue.

The specific plans to be audited had the following profile: their plan year ended in 1986, 1987, or 1988;[2] they covered one to five participants; generally, but not always, their annual contribution was $100,000 or more; they were valued with an interest assumption of less than 8 percent; and the normal retirement age of the plan was less than age 65.[3] Apparently, it was estimated that deductions would be retroactively disallowed in 85 percent of the plans to be examined.

As it turned out, the program fell considerably short of its expectations. Although all the audits under the program were concluded by July 31, 1992, only $38 million in revenue had been produced by December, 1992, and the program appeared to be floundering.[4] In retrospect this is not surprising, almost immediately the effort met with intense and unrelenting resistance from small plan actuaries, their associations and their advocates.

It was not long after the small plan audit program was instituted before several of the ensuing cases reached the Tax Court. In due course, these cases were assigned to Judge Charles E. Clapp II, who, after observing that there were likely to be many more such cases, selected some representative ones for trial. His stated intent was to develop judicial precedence and guidance so that subsequent cases could be resolved without costly litigation.

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[2]These plan years were chosen because the statute of limitations was ended for plan years prior to 1986 (IRC §6501) and the tax law changed for plan years which ended after 1988. The primary relevant changes in the tax law were the revision of the full-funding limitation to include current liability (IRC §412(b)(5),(c)(7) and (l)(7)) and the amendment to IRC §412(c)(3), which required that *each* actuarial assumption (rather than actuarial assumptions in the aggregate) be reasonable.

[3]Internal memorandum to IRS field agents dated November 29, 1989.

[4]See BNA Pension Reporter (12/7/92), p. 2159.

The cases were composed of two institutional and eight noninstitutional cases. The two institutional cases were the first to be tried, and involved large successful law firm partnerships which had adopted individual defined benefit (IDB) plans for their partners.[5] The firms were the Texas-based firm of Vinson & Elkins and the New York firm of Wachtell, Lipton, Rosen & Katz (Wachtell Lipton). In both instances, assumptions used for valuing their plans were deemed unreasonable by the IRS, which sought to disallow their deductions. These cases were tried on January, 1992 and a decision was handed down in the following July.

The remainder of the cases involved small businesses engaged in a variety of activities, each of which had a small defined benefit pension plan for one or two key employees. Since the cases arose under an audit program in Phoenix, they came to be known as the "Phoenix cases," but subsequently were referred to as "Citrus Valley" since they were consolidated and tried as Citrus Valley Estates, Inc., et. al.[6] In addition to actuarial assumption challenges, these cases involved frontloading of the contribution under the unit credit funding method. The cases were tried in February, 1992 and a decision was handed down in the following September.

The purpose of this article is to analyze these cases and their implications. First, the issues contested by the IRS are summarized. Then, the opinions of the Court as they relate to these issues are discussed. The paper ends with a comment on the implications of the Court's opinions.

The Issues Contested by the IRS

In general, the actuarial issue raised by the IRS was whether actuarial assumptions used by the enrolled actuary to determine the plans' costs were reasonable in the aggregate and represented the actuary's best estimate of anticipated experience under the plans as required by IRC §412(c)(3). The specific issues contested by the IRS are summarized in Table 1.[7] For example, for the institutional plans the IRS contested the 5-percent preretirement and postretirement interest rate assumption, the normal retirement ages of 55 and 62, the 5-percent and 7.5-percent expense loads, and the preretirement mortality assumption. Moreover, the IRS contended that those assumptions were not offset by any

[5]In view of IRC §401(a)(26), individual defined benefit plans of this type are no longer allowed, and these plans have all been terminated.

[6]Citrus Valley Estates, Inc. , Robert J. and Janice A. Davis, Old Frontier Investment, Inc., Lear Eye Clinic, Ltd., Robert Stephan jr., Ltd., Boren Steel Consultants Inc., Arizona Orthopedic Institute of Traumatic and Reconstructive Surgery, Jonathan R. and Renee K. Fox, and Brody Enterprises, Inc. Although separately docketted, Arizona Orthopedic is a successor to Jonathan Fox.

[7]This paper does not deal with the nonactuarial issues of these cases, which included timing of amendments, automatic approval of a cost method change, and validation of hours worked.

other assumptions that would make the assumptions in the aggregate reasonable.

Table 1
Actuarial Issues Contested by the IRS

	Interest Rate			Expenses		Mort. table		Cost Method
	pre-	post-	NRA	pre-	post-	pre-	post-	
Institutional cases	5%	5%	55 &62	7.5%	5/7.5%	✓		
Citrus Valley et. al.	5%	5%	55		6/4.5%		✓	✓

Most of the issues of Table 1 are self-evident,[8] however, those related to the mortality tables and the cost methods need clarification. For the institutional cases, the IDB plans that contained life insurance used the 1958 CSO mortality table for the preretirement mortality assumption and the 1971 IAM table for the postretirement mortality assumption. While the IRS agreed that such plans may provide a pre-retirement death benefit, and may fund these benefits using envelope funding,[9] it contested the use of the 58 CSO table, on the grounds that it grossly overstated the expected actual mortality experience.

The situation for the Citrus Valley plans was somewhat different. In one instance, an insurance company's guaranteed female annuity table was used for a plan with a single male participant; in another, a female mortality table with a 7-year age setback was used for a plan with a single male participant; and in another, an age setback was used for a participant with a substandard family medical history. The IRS contested the mortality assumption in each instance.

As indicated, the IRS contested the actuarial cost method in a significant number of the Citrus Valley cases. The issue was straightforward. These plans provided for the accrual of all, or a significant portion, of the benefits provided under the plan in a very few years, a procedure commonly referred to as "frontloading." Using the unit credit funding method, the benefits were then funded as they accrued, with the contribution currently deductible. The IRS contended that while frontloading of benefit accruals is permissible from a qualification standpoint, an equivalent frontloading of the deductible contribution is not permitted.

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[8]Some of these plans could only be differentiated on the basis of their "credible" experience. It had been anticipated that the Court's decision would be materially affected by plan experience, but this turned out not to be the case.

[9]The envelope method may be used with any cost method and with any type of insurance policy. It is the method which is generally used with unit credit, or with insurance policies which do not have guaranteed projected cash values at retirement. Under the envelope method, assets are adjusted by adding the cash value of the insurance as of the valuation date. The normal cost and accrued liability are calculated using the adjusted assets.

The IRS argued that an interest rate less than 8% was unreasonable so that the cost estimates had been overstated. Conceptually, their argument is shown in Figure 1, where the top curve shows the cost estimate based on a 5 percent interest rate and the bottom curve shows the cost estimate based on an 8 percent interest rate.

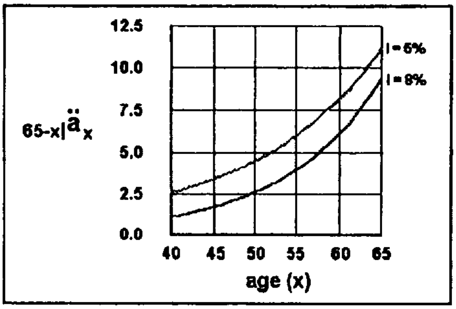

Figure 1: Estimated cost v. interest rate

Similarly, the IRS argued that a normal retirement age of less than 65 was unreasonable and lead to an overestimate of deductible pension costs. Figure 2 conceptualizes their argument. Once again, the top curve, which shows a higher cost, represents the cost estimate based on a 5 percent interest rate.

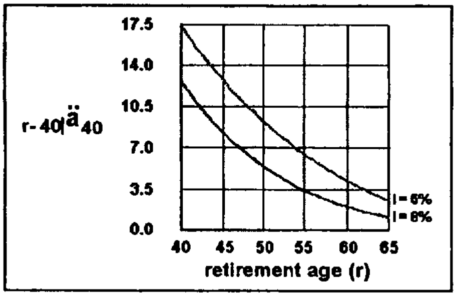

Figure 2: Estimated cost v. retirement age

The Findings of the Tax Court

As discussed below, the Court generally found against the IRS on most of the issues. In the institutional cases, for example, the Court held that "[t]he actuarial assumptions made by the plans' enrolled actuary were reasonable in the aggregate and represented the actuary's best estimate of anticipated experience under the plans, as required by §412(c)(3); accordingly, as the assumptions used were not substantially unreasonable, [the IRS] is precluded from requiring a retroactive change of assumptions."

Similarly, for the noninstitutional cases, the Court held that all of the challenged actuarial assumptions for each of the plans at issue were reasonable. Further, the certifying actuaries for the plans using the unit credit funding method funded within allowable limits and made reasonable allocations of costs, except for one plan which was complicated because of an amendment issue.[10] Accordingly, the actuarial assumptions and methods used for the plans are reasonable in the aggregate. A fortiori, these assumptions are not substantially unreasonable so as to permit retroactive changes of assumptions for years prior to the year in which the audit was made.

The outcome of the cases were by no means obvious prior to the decisions and it is interesting and informative to read how an unbiased legal authority interprets the actuarial issues involved. The following is a recapitulation of how the Court reached its conclusions.

Deference to the Enrolled Actuary

A major conclusion was that deference must be given to the assumptions chosen by the Enrolled Actuary who certifies the funding of the plan. In this regard, Judge Clapp gave his interpretation of Congressional intent the full weight of legal authority.

Judge Clapp emphasized that in enacting ERISA, Congress was well aware that actuaries would play a major role in ensuring that retirement plans would be sufficiently able to provide retirement income when due. He observed that Congress recognized the importance of the actuarial assumptions and cost methods chosen by actuaries in determining plan funding amounts and that it explicitly noted that such determinations by actuaries would involve making predictions and would be a matter of judgment involving many factors and producing a range of results. He also commented that Congress decided that accepting a range of reasonableness for funding amounts for retirement plans would be more desirable and more effective than imposing an inflexible legislative standard on actuaries and, therefore, rejected imposing mandatory funding assumptions and methods.[11]

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[10]Citrus Valley, p. 101.

[11]Wachtell Lipton, pp. 10-11.

The Interest Rate Assumption

The Judge Clapp concluded that a 5 percent interest rate assumption was not unreasonable. He also clarified the role of a prudent actuary insofar as the selection of the interest assumption. He noted that the actuary's primary duty to plan participants under ERISA is to establish a realistic contribution pattern over the long term so that the plan sponsor will provide adequate funding for the ultimate pension obligation. Thus, in selecting actuarial assumptions, prudent actuaries maintain a long-term conservative view that will ensure benefit security for plan participants.[12]

Rejecting the IRS's contention that 8 percent would have been a reasonable interest rate assumption because that amount could have been earned during the years at issue, the Court commented that "Congress did not entrust the Nations's tax advantaged retirement savings system to hypothetical returns that the markets "should" bear."[13]

Particularly noteworthy was the fact that the Court attached only minor importance to the testimony and reports of nonactuaries, in spite of the fact that they were experts in the field of investment. The Court reasoned that if a financial analyst's predicted rate is higher than the actual rate earned, the investor simply earns less than he supposed he would earn, whereas if an actuary makes the same mistake, there is a significant risk that the plan will become underfunded and the pensioners' full benefits will be unpaid.[14]

Retirement Age Assumption

The Court seemed willing to accept a normal retirement age (NRA) assumption which was less than age 65 as long as it was based on reasons that were "sincere, credible, and reasonable." It explicitly rejected the IRS's argument that statements by the participant in a one-person plan were "merely self-serving," even when there was no evidence that the underlying reasons had been explained to the plan actuary.[15]

The IRS had taken the position that if a key participant does not retire at the assumed normal retirement age, that is clear evidence that the assumption was unreasonable. In rejecting this position, the Court noted that "... the certifying actuary is not charged with the responsibility of determining when a plan participant will actually begin to receive the plan benefits. That would be an impossible task. Further, the fact that a plan participant might chose to, or actually does, delay receipt of the plan benefits beyond the

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[12]Vinson & Elkins, p. 27.

[13]Vinson & Elkins, p. 49.

[14]Citrus Valley, p. 71.

[15]See, for example, Citrus Valley, p. 83.

assumed retirement age does not make the retirement age assumption unreasonable. An actuary is charged with looking into the future and making a determination as to, among other things, when benefits under the plan could begin."[16]

Expense Loadings

The court held for the taxpayer in each instance where the IRS challenged the expense loading. In the institutional cases, while Judge Clapp had some misgivings about the 7.5 percent expense loading, he found it not to be substantially unreasonable and acceptable on the basis of reasonable in the aggregate.

In the noninstitutional cases, he rejected the IRS's argument that expense loadings are merely a device to increase deductions. His opinion observed that "[the IRS] offered a rather perfunctory rebuttal, stating simply that [the] addition of postretirement expense load assumptions would further increase the funding goal and the amount of the deduction. ... This is not, however, unreasonable per se, as [the IRS] seems to believe. ... A postretirement expense load is a reasonable manner in which to fund the postretirement administrative fees."[17]

Mortality Assumptions

The Court found that it was reasonable for the institutional cases to use the 1958 CSO mortality table to compute the cost of the preretirement death benefit. It explicitly rejected the IRS's arguments that: (1) a preretirement mortality assumption was unreasonable in a one-person plan; and (2) even if it was appropriate to use a preretirement mortality assumption, it was unreasonable to assume the 1958 CSO mortality table for the preretirement mortality and the 1971 IAM table for the postretirement mortality for the same person, since the tables are incompatible. As the Court pointed out, the probability of the participant's preretirement death was not at issue. The issue was to estimate the life insurance premium expense, and this could be best done by using the same type of mortality table as would be used by the insurance company.[18]

In the noninstitutional cases, while the Court was "not entirely convinced that the mortality assumption ... is completely reasonable, it is not substantially unreasonable so as to justify a retroactive adjustment."[19] Thus, even in situations as extreme as the case involving a male participant which used the 1983 IAM table for females with a 7-year age

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[16]Vinson & Elkins, p. 58.

[17]Citrus Valley, p. 91.

[18]Vinson & Elkins, p. 67.

[19]Citrus Valley, p. 87.

set-back, the mortality assumption was implicitly approved by the Court in its approval of the funding assumptions in the aggregate.

The Unit Credit Funding Method

One of the surprises to emerge from the Citrus Valley cases was that the Court found against the IRS on the frontloading issue under the Unit Credit Funding Method. The IRS had previously won the well-publicized Mirza case,[20] where the same issue was in question and their same argument was used. In the Mirza case, the Court agreed with the IRS's interpretation that §404(a)(1)(A)(iii) provides that the maximum that can be deducted in any year is the "normal cost" plus an amount necessary to amortize "past service" and other supplementary cost over 10 years, as determined under regulations prescribed by the Secretary. It reasoned that "[i]t is simply inconceivable that Congress would take pains to provide for the amortization of past service credits but intended to allow taxpayers to circumvent this requirement by the device of structuring their plans to accrue benefits in a single year."[21]

However, Judge Clapp enumerated three reasons for rejecting the Mirza conclusion.[22] First, "[t]he language of §404(a)(1)(A)(iii) setting forth the limit on deductible contributions used the conditional phrase 'if *** provided by the plan' when setting forth the treatment for past service cost" Thus, there would only be a past service liability if it was provided for by the plan. Second, "[d]espite [the IRS's] assertions to the contrary, there is no express[ed] or implied connection between the limitations of §415 and any allocation under §1.412(c)(3)-1(e)(3)."[23] That is, there is no requirement that the allocation between normal cost and past service liability be consistent with the limitations on benefit accruals. Third, "the Unit Credit Funding Method -- in connection with a career-average pay plan -- inherently allocates benefits in a reasonable manner to the past and future years of service for which benefits accrued and will accrue."

Of course, this finding is only relevant for plan years beginning prior to 1987, since the approach discussed is not possible for plan years beginning after December 31, 1986. This follows since the Tax Reform Act of 1986 amended §415(b)(5) so that the dollar limitation is phased in over the first 10 years of participation in a plan rather than 10 years of service with the plan sponsor.

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[20]Jerome Mirza & Associates, Ltd. v. United States, 882 F.2d 229 (7th Cir. 1989).

[21]Ibid. at 232.

[22]Citrus Valley, pp. 104-5.

[23]Citrus Valley, p. 99.

Evidentiary Matters

The IRS has consistently objected to the use by actuaries of its training manuals, audit guidelines, internal and external correspondence, and transcripts of speeches made by Service employees regarding the matters at issue in these cases. However, the Court concluded[24] that actuaries can take into account IRS documents that have been disseminated publicly since "they are part of the actuarial universe within which all actuaries must live, think, and work in arriving at their conclusions as to reasonableness and their best estimates regarding appropriate contributions." Moreover, they can be guided by the speeches of high-ranking Service employees.

Implications

There seems to be a consensus among small plan attorneys that the opinions rendered in these cases are likely to be afforded considerable credibility.[25] Not only are they "lengthy, studious and thoroughly analyzed" but they are based to a large extent on "factual conclusions," which makes them difficult to overturn.[26] Moreover, 14 of 15 participating Tax Court judges in the Phoenix cases concurred with the opinions.

It is difficult to anticipate how the Courts will react in future cases where the issues are similar, but the facts and circumstances are materially different. However, the following basic principles seem to have emerged:

1. The intent of Congress is that deference should be given to the assumptions chosen by the Enrolled Actuary;

2. While assumptions are required to be reasonable and Congress did not permit actuaries unfettered liberty,[27] the pragmatic test is that assumptions are not

[24]Vinson & Elkins, pp. 75-77.

[25]See, for example, Katz, Harvey M. "A Death Knell for the Small-Plan Program," Society of Actuaries' **Pension Section News** (December 1992), p. 1 and Reish, C. Frederick and Bruce L. Ashton, "The Phoenix Tax Court Decisions: What the Taxpayers Won" **The Pension Actuary** (December, 1992), p. 3.

[26]Reish, C. Frederick and Bruce L. Ashton, "Actuarial Audits: The Tax Court Decisions," **The Pension Actuary** (August, 1992), p. 5.

[27]The Court specifically noted that it was the intent of Congress that actuaries should not sell their expertise to achieve tax-desired results rather than prudent plan funding.

"substantially unreasonable;"[28] and

3. When formulating assumptions, it is appropriate for the actuary to be guided by the "sincere, credible, and reasonable" expectations of the plan sponsor and IRS documents and insights that have been publicly disseminated.

In the past, actuaries have struggled to formulate a workable interpretation of pension laws and regulations for the small plan area. In most cases, actuaries are not attorneys, and while their own interpretation of these laws and regulations may have seemed reasonable to them, there has been a need for an authoritative unbiased interpretation. These cases, with their scholarly exposition of these rules and regulations, have done much to help clarify some of these issues.

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