1993

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The Small Plan Audit Program:  
The Opinions of the Court

Arnold F. Shapiro*

Abstract

One of the most important issues of recent years from the perspective of many pension actuaries is the IRS's small plan audit program. The program initially was expected to raise two-thirds of a billion dollars by targeting well-funded defined benefit plans with five or fewer participants. The focus of the audit was the assumed interest rate and the normal retirement age, both of which the IRS generally regarded as too low.

While the focus of the audit was relatively narrow, the issue it raised was a fundamental one. The basic question was the extent to which the IRS could impose its unilateral interpretation of actuarial principles on pension actuaries.

Not surprising, many small plan audit cases ended in the tax courts. In due course decisions and opinions have been rendered in three lead cases. This article presents the opinions of these cases as they relate to actuarial practice and discusses some of their implications.

Key words and phrases: defined benefit plans, actuarial assumptions, unit credit method, IRS

1 Introduction

One of the most important issues of recent years from the perspective of many pension actuaries is the Internal Revenue Service's (IRS) small plan audit program.1 The program began in November 1989, when the IRS2 initiated a nationwide plan to audit the actuarial assumptions of approximately 18,000 small well-funded defined benefit plans.

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1 Even though this paper deals only with court cases in the United States, the opinion of the court may have implications in any country where actuarial assumptions are at issue.

2 Throughout this paper, the abbreviation IRC means the Internal Revenue Code and the abbreviation IRS refers to the Internal Revenue Service of the U.S.
Fit pension plans. The program initially was expected to raise two-thirds of a billion dollars in additional tax revenue.

The specific plans to be audited shared several characteristics:

- The plan year ended in 1986, 1987, or 1988;3
- The plan covered one to five participants;
- The plan annual contribution generally, but not always, was $100,000 or more;
- The plan was valued with an interest assumption of less than 8 percent (IRS memo, November 29, 1989); and
- The normal retirement age of the plan was less than age 65.

It was estimated that deductions would be disallowed retroactively in 85 percent of the plans to be examined.

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; see the BNA Pension Reporter (1992). In retrospect this is not surprising because the effort immediately met 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. 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.

The suits comprise two institutional and eight noninstitutional cases. The two institutional cases, the first to be tried, involved large successful law firm partnerships that had adopted individual defined benefit (IDB) plans for their partners.4 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

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3 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 that 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 requires that each actuarial assumption (rather than actuarial assumptions in the aggregate) be reasonable.

4 In view of IRC §401(a)(26), individual defined benefit plans of this type no longer are allowed, and these plans have been terminated.
These cases were tried in January 1992, and a decision was handed down the following July.

The remainder of the cases involved a variety of small businesses, each of which had a small defined benefit pension plan for one or two key employees. Because 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 because they were consolidated and tried as Citrus Valley Estates, Inc. et al. These cases involved frontloading of the contribution under the unit credit funding method in addition to actuarial assumption challenges. The cases were tried in February 1992, and a decision was handed down the following September.

This article presents the opinions of the court as they relate to the actuarial practice associated with small defined benefit plans and discusses some of their implications. First, the actuarial issues contested by the IRS are summarized. Then the opinions of the court relating to these issues are discussed. The paper ends with a comment on the implications of the court's opinions.

2 The Actuarial Issues Contested by the IRS

The general 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. For example, for the Vinson & Elkins plans the IRS contested the 5 percent preretirement and postretirement interest rate assumption, the normal retirement age of 62, the 5 percent postretirement expense load, and the preretirement mortality assumption. Moreover, the IRS contended that these assumptions were not offset by any other assumptions that would make the assumptions reasonable in the aggregate.


6 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.
Most of the issues of Table 1 are self-evident, but 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 Commissioners Standard Ordinary (CSO) mortality table for the preretirement mortality assumption and the 1971 Individual Annuity Mortality (IAM) table for the postretirement mortality assumption. While the IRS agreed that such plans may provide a preretirement death benefit and may fund these benefits using envelope funding, it contested the use of the 1958 CSO table on the grounds that it grossly overstated the expected actual mortality experience.

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

8 The envelope method may be used with any cost method and with any type of insurance policy. It is the method that generally is used with the unit credit funding method or with insurance policies that 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 situation in Citrus Valley 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 seven 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.

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 then were 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 and that no more than 10 percent of the maximum benefit may be allocated to a given year's normal cost, just as the maximum benefit that can be provided to a participant with one year of service is 10 percent of the overall IRC §415 limit.

3 The Experts

Before proceeding to the findings of the court, it is worth noting the credentials of the experts chosen by each side and the focus of their testimony or report.

3.1 The Institutional Cases

The experts for institutional cases included James F. Rabenhorst, managing partner at Price Waterhouse, who testified regarding the retirement age assumption; Richard R. Joss, Ph.D., F.S.A., M.A.A.A, E.A., resource actuary for the Wyatt Company, who testified regarding the actuarial assumptions; Mary S. Riebold, F.S.A., M.A.A.A., E.A., F.C.A., managing director for Mercer and then-president of the Conference of Consulting Actuaries, who testified regarding the actuarial assumptions; Steven H. Schechter, director of management information systems at Wolper Ross, who testified regarding interest rate assumptions based on an analysis of Form 5500 data; and John W. Peavy III, Ph.D., C.F.A., professor of finance at Southern Methodist University, who served to rebut the contentions of Shapiro and Haneberg regarding the interest rate assumption.
The experts for the IRS in these cases included Ronald L. Haneberg, J.D., F.S.A., M.A.A.A., F.C.A., previously a consulting actuary with Buck Consultants, who testified regarding the actuarial assumptions; Claude Poulin, F.S.A., M.A.A.A., E.A., president of Poulin Associates, Inc., who testified regarding the actuarial assumptions; Alan C. Shapiro, Ph.D., professor of banking and finance at the University of Southern California, who testified regarding the interest rate; William S. Borden, Ph.D., senior program analyst at Mathematica Policy Research, who testified regarding the investment return and in rebuttal to Joss; and Jeffrey F. Jaffe, M.B.A., Ph.D., associate professor of finance at the Wharton School, who provided an expert report on the validity of the interest rate assumption.

3.2 Citrus Valley Estates, Inc. et al.

The experts for Citrus Valley included Kenneth D. Klingler, F.S.A., M.A.A.A., E.A., a consulting actuary with the Wyatt Company, who testified regarding the assumptions; and Arthur W. Anderson, A.S.A., M.A.A.A., E.A., who previously had been a consultant for William M. Mercer, Johnson & Higgins, and the Wyatt Company and was the author of Pension Mathematics for Actuaries, testified as an expert with respect to the unit credit funding method.

The experts for the IRS included J. Ruben Rigel, J.D., F.S.A., F.C.A., M.A.A.A., E.A., who testified with respect to the assumptions and the unit credit funding method; Roger Ibbotson, M.B.A., Ph.D., president and chief executive officer of Ibbotson & Associates, Inc., who testified with respect to the interest rate assumption; William S. Borden, Ph.D., who testified with respect to the interest rate and retirement age assumption; and James E. Holland, A.S.A., E.A., chief of the Pension Actuarial Branch of the Service, who provided an expert report dealing with the unit credit funding method.

4 The Findings of the Tax Court

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."
The court held similarly for the noninstitutional cases 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 that was complicated because of an amendment issue (Citrus Valley, p. 101). Accordingly, the actuarial assumptions and methods used for the plans were reasonable in the aggregate. *A fortiori,* these assumptions were not substantially unreasonable in order to permit retroactive changes of assumptions for years prior to the year in which the audit was made.

The outcomes of the cases were not obvious prior to the decisions. 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.

4.1 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 Congress was aware in enacting ERISA 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 the cost methods chosen by actuaries in determining plan funding amounts and that Congress 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 (*Wachtell Lipton,* pp. 10-11).

4.2 The Interest Rate Assumption

In reaching his decision on the interest rate assumption, Judge Clapp identified what he regarded as particularly important factors. He noted that the combination of these factors weighed heavily
in favor of concluding that 5 percent was reasonable. For the institutional plans these factors were (Vinson & Elkins, p. 46):

- The nature of the responsibility Congress entrusted to enrolled actuaries in the statutory scheme enacted for defined benefit pension plans;
- The conservative nature of the actuarial assumption selection process;
- The fact that IDB plans were long-term plans, with funding to occur over a 30 year to 50 year period;
- The fact that IDB plans were self-directed, with each participant being a co-administrator, especially because most of the IDB plans did not employ a professional manager;
- The fact that IDB plans lacked credible experience with respect to earnings, investment strategies, and otherwise;
- The risk of losing compounded earnings in a tax-exempt trust associated with using overly optimistic assumptions and the resulting requirement for unanticipated higher contributions in later years;
- The relative closeness of all the actuarial experts' reasonable ranges; and
- The fact that most actuaries used interest rate assumptions of between 5 percent and 6 percent for small plans during the years at issue.

He listed the same factors, except for the relative closeness of the reasonable ranges, for the noninstitutional plans (Citrus Valley, p. 69).

Judge Clapp also clarified the role of a prudent actuary in 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, prudent actuaries maintain a long-term conservative view that

9 It is relevant that each partner/participant served as a coadministrator because that meant that the plan assets of the IDB plans were not commingled for the purpose of investment and, therefore, could not realize the rates of return earned by larger plans.

10 Not all the experts agreed that their reasonable ranges were close. See, for example, Ronald L. Haneberg, "Not All Experts Agree," Enrolled Actuaries Report (November, 1992), p. 3.

11 This conclusion follows from Schechter's testimony that actuaries established interest rate assumptions between 5 percent and 6 percent for 1986 plans with fewer than 100 participants for 76.6 percent of the preretirement assumptions and 82.5 percent of the postretirement assumptions. Schechter's conclusions were based on his analysis of data obtained from the Department of Labor.

The court was not swayed by the IRS's contention that rates in general use during the time were irrelevant.
will ensure benefit security for plan participants in selecting actuarial assumptions (Vinson & Elkins, p. 27)

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 nation's tax-advantaged retirement savings system to hypothetical returns that the markets 'should' bear" (Vinson & Elkins, p. 49).

Particularly noteworthy is 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. This was true, for example, even with the testimony of the well-known Roger Ibbotson. The rationale was that these persons were not actuaries and that conclusions they drew would have limited application in the determination of the reasonableness of actuarial assumptions (Vinson & Elkins, p. 47). The court reasoned that if a financial analyst's predicted rate is higher than the actual rate earned, the investor simply earns less than expected, 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 (Citrus Valley, p. 71).

4.3 Retirement Age Assumption

The court seemed willing to accept a normal retirement age (NRA) assumption that 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. (See, for example, Citrus Valley, p. 83.)

The IRS took the position that failure of a key participant to retire at the assumed normal retirement age was 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 choose to, or actually does, delay receipt of the plan benefits beyond the assumed retire-

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12 Ibbotson & Associates, Inc. sells financial software and data and provides consulting services to investment management firms. Roger Ibbotson is an often-quoted authority on stocks, bonds, Treasury bills, and inflation.
ment 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" (Vinson & Elkins, p. 58).

Some of the Citrus Valley plans contained a segregated account provision, which meant that at the normal retirement age benefits were segregated into a separate account even if the participant chose to continue working beyond that age. The present value of accrued benefits at the normal retirement age is treated in effect as an account balance in a defined contribution plan. The experts of both parties agreed that the inclusion of a segregated account provision in a plan rendered the date of a participant’s actual retirement irrelevant (Citrus Valley, p. 75).

Given that the experts agreed, the court concluded that the segregation provision justified the finding that it was reasonable for the assumed retirement age to be the normal retirement age stated in the plan, because that would be the age at which the participant would elect to segregate the accrued benefits. This obviated the retirement issue for a number of plans that had a normal retirement age of 55.

4.4 Expense Loadings

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

He rejected the IRS’s argument in the noninstitutional cases that expense loading is 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” (Citrus Valley, p. 91).

4.5 Mortality Assumptions

The court found that it was reasonable in the institutional cases to use the 1958 CSO mortality table to compute the cost of the pre-retirement death benefit. It explicitly rejected the IRS’s arguments that a preretirement mortality assumption was unreasonable in a one
person plan and that even if it were 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 because 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 done best by using the same type of mortality table as would be used by the insurance company (Vinson & Elkins, p. 67).

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” (Citrus Valley, p. 87). Thus, even in situations as extreme as the case involving a male participant that used the 1983 IAM table for females with a seven year age setback, the mortality assumption implicitly was approved by the court in its approval of the funding assumptions in the aggregate.

4.6 The Unit Credit Funding Method

One of the surprises to emerge from the Citrus Valley cases was the court finding against the IRS on the frontloading issue under the unit credit funding method. The IRS previously had won the well-publicized Mirza case (Jerome Mirza & Associates, Ltd. v. United States, 882 F.2d 229 (7th Cir. 1989)), where the same issue was in question and the same argument was used. In Mirza, the court agreed with the IRS’s interpretation that IRC §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 ten 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” (Mirza, p. 232)

Judge Clapp enumerated three reasons for rejecting the Mirza conclusion (Citrus Valley, pp. 104-105). 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 be only a past service liability if it were provided 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)” (Citrus Valley, p. 99). 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.”

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

4.7 Evidentiary Matters

The IRS consistently has objected to actuaries’ use 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. The court concluded (Vinson & Elkins, pp. 75-77), however, that actuaries can take into account IRS documents that have been disseminated publicly because “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, actuaries can be guided by the speeches of high-ranking Service employees.

One specific comment that had been referenced by many pension actuaries is the highly publicized transcript of the Ira Cohen speech at the 1986 Enrolled Actuaries meeting, wherein he stated that a 4 percentage point corridor on either side of the prevailing long-term Treasury bond rate was within the reasonable range of interest rate assumptions. In spite of the fact that Cohen was the director of the Actuarial and Technical Division of the Service at the time of the speech, the IRS claimed that he had not spoken for the Service and, moreover, the speech was merely hearsay. The court disagreed with the IRS’s position, and asserted that such a speech, heard by many actuaries and disseminated by publication to many more, is not hearsay, as long as the transcript is “true and correct.”
5 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.\textsuperscript{13} 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; see Reish and Ashton (1992). 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. The following basic principles, however, seem to have emerged:

- The intent of Congress is that deference should be given to the assumptions chosen by the enrolled actuary;
- While assumptions are required to be reasonable and Congress did not permit actuaries unfettered liberty,\textsuperscript{14} the pragmatic test is that assumptions are not "substantially unreasonable;"\textsuperscript{15} and
- 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 small plans. In most cases, actuaries are not attorneys, however—while their 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 the rules and regulations, have done much to help put things into perspective.

References


\textsuperscript{13} See, for example, Katz, Harvey M., "A Death Knell for the Small-Plan Program," p. 1 and Reish, C. Frederick, and Bruce L. Ashton, "The Phoenix Tax Court Decisions: What the Taxpayers Won," p. 3.

\textsuperscript{14} 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.

\textsuperscript{15} It is worth noting that the two main assumptions considered (the interest rate and the retirement age) were argued successfully on an individual basis, rather than an aggregate basis, so that the conclusions reached are still appropriate.
Arnold F. Shapiro  
Small Plan Audit Program

Citrus Valley Estates, Inc. et al. v. Commissioner, 99T.C. No. 21, No. 12900-89 etc., September 29, 1992


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


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


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