

Section 404 Is Not Just About Deductibility Anymore

The Academy's Committee on Pension Accounting prepared this article under the direction of Committee Chairperson Mark Beilke.

INTERNAL CONTROLS AND THE ACTUARY

WHEN ENRON COLLAPSED and the public was besieged with numerous allegations of accounting scandals, Congress responded by passing the Sarbanes-Oxley Act of 2002. The legislation places new controls on the development and auditing of corporate financial statements to assure the investing public that information in the statements accurately reflects the economic viability of publicly traded companies and thereby strengthens the nation's domestic financial market.

The legislation emphasizes the need for an auditing firm to be independent from the corporations it audits by further restricting the manner in which it may interact with its audit clients. It also adds personal responsibility for the accuracy of

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EAR

ENROLLED ACTUARIES REPORT



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EAR
ENROLLED ACTUARIES REPORT

The *Enrolled Actuaries Report* is a quarterly publication of the American Academy of Actuaries (www.actuary.org).

MOTIVATING THE REBIRTH OF DB PENSION PLANS

Capital Gains Rates in Retirement

BY JAMES BERBERIAN

MOST PEOPLE CAN APPRECIATE the value of a guaranteed lifetime retirement annuity, and actuaries are not the only voters who believe that our nation's well-being and stability can be enhanced through reliable retirement plans. However, defined benefit pension (DB) plans have declined in popularity among employers due to administrative complexity, funding volatility, and regulatory uncertainty. Reducing these burdens should be one legislative focus. But to motivate the creation of new DB plans, our leaders should consider a new and powerful incentive: capital gains tax treatment.

Long-term capital gains tax rates are appropriate for annuity retirement distributions. DB plans must be funded over long periods, and because all participants' assets are invested collectively, investment "churning" is not common. This is in contrast to typical 401(k) programs, which allow frequent—often daily—investment changes by participants.

Over the career of an average worker, a large portion of the eventual retirement benefit is provided by long-term investment return. The ability to treat employer-provided annuity payments from qualified DB trusts as capital gains would offer sponsors a considerable incentive to reintroduce such

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plans. Especially in the case of higher-paid decision-makers, reduced taxation in retirement—relative to ordinary income tax rates—would be quite attractive. Lower-paid participants would benefit as well.

Implementing such a significant tax change would require some safeguards and phase-ins to be feasible. First, benefits taken as lump sums, or other rapid forms of payment that are rollover eligible, should not receive capital gains status. This is consistent with annuities being, almost by definition, long-term investments, while lump sums become personal accounts.

Additionally, there should be a participation service require-

Treating annuity payments from qualified DB trusts as capital gains would offer sponsors an incentive to reintroduce such plans.

ment to earn capital gains status for annuity benefits. Perhaps 10 years of participation (as defined for purposes of Internal Revenue Code Section 415) could trigger full capital gains treatment, with lesser participation leading to pro-rata capital gains status. For example, a \$1,000-per-month annuity that was earned over seven years of participation would be treated for tax purposes as \$700 of capital gain, and \$300 of ordinary income.

To phase in such a change in the tax code, legislation could limit participation service for this purpose to years earned after Jan. 1, 2005 (or any other effective date). It would also seem appropriate to count years of benefit deferral, between termination of employment and eventual benefit commencement,

toward the determination of capital gains status. For instance, an employee leaving with a vested benefit after five years of participation would have the option of waiting five (or more) years to begin receiving annuity payments and thereby take full advantage of capital gains rates.

Capital gains status could also be effective motivation for sponsors that might otherwise terminate their plans to continue those programs. In the event of plan termination, annuity benefits purchased through an insurance company would maintain capital gains treatment—to the extent applicable—while lump sum distributions, which are especially attractive to owner-participants, would not. Again, protecting a secure retirement income is rewarded with more favorable tax treatment.

Eligibility for capital gains status could also be modified to ensure that wealthy employees do not benefit disproportionately. For example, years of participation could be counted at 50 percent during periods that the participant is classified as highly compensated. In effect, it would take 20 years for the highest-paid participants to fully earn capital gains treatment. Alternatively, the monthly benefit eligible for capital gains treatment could be capped; for example, at the PBGC guaranteed benefit level (currently about \$3,700 per month).

If we are to preserve DB plans as a viable concept for the next generation of retirees, lawmakers must provide new incentives to create and maintain such programs. Reducing regulatory complexity is an enviable goal, but significant new inducements—like capital gains tax treatment—will also be necessary.

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Letter to the Editor

REVIVING DB PLANS

WAS GOING THROUGH A FEW ITEMS in my reading pile, and the winter 2003 *EAR* was one of them. The last section of your article (“Retirement Revolution”) hinted at working to better educate the public about the merits of defined benefit (DB) plans. Has the Academy been making progress in this area?

Several of my colleagues are concerned about the future. One can envision a future where all of the baby boomers retire and find that they don’t have enough retirement income to survive because they lack DB plans and sufficient retirement savings, forcing the government to step in to help. That translates into a heavy tax burden for me and my children, who are left to provide a windfall to the baby boomers. Simultaneously, many plan sponsors are freezing and terminating their current DB plans.

I believe now is a critical time in our country’s history. If DB plans were suddenly made administratively simple, then we might see companies implement new DB plans in time for late-career active employees to accrue meaningful retirement benefits. I think we not only should be educating the public but also working with the government, FASB, and others to simplify everything.

Can you give me a few details as to what the Academy has been up to in this area that I can pass along to my concerned colleagues?

James Sincovec
Dallas

ACADEMY PENSION VICE PRESIDENT KEN KENT REPLIES:

AS YOUR LETTER POINTS OUT, the need for public education on the merits of DB plans is critical. In fact, the importance of public financial education was a dominant theme to emerge from discussion at the Defined Benefit Symposium, convened last March by the Academy and the Conference of Consulting Actuaries.

So what are we doing at the Academy to educate the public? Our first focus is educating that portion of the public who influence retirement security policy. Toward that end, we invest the time and efforts of volunteers (professionals like you and me) in developing issue briefs that define and explain actuarial concepts—like conversion, whipsaw, collar mortality—that provide significant context in understanding DB systems.

Some recent examples (all available on the Academy’s website) are:

- ▶ *What’s Whipsaw? Why Is It a Problem?* (www.actuary.org/pdf/pension/whipsaw_feb03.pdf)
- ▶ *DB-K Plus: A Defined Benefit Plan With 401(k) Features* (www.actuary.org/pdf/pension/dbk_jan03.pdf)
- ▶ *When Your Retirement Plan Changes: Understanding Your Cash Balance Plan* (www.actuary.org/pdf/pension/cashbook.pdf).

This year we also prepared election guides for policy-makers, journalists, and voters to use as they examine candidates’ proposals on Social Security and Medicare (both are also available on the Academy’s website, www.actuary.org/election04.htm).

What are we planning for the near future? The Academy’s Pension Practice Council and Pension Committee are working

on a number of initiatives, notably the completion of a paper on pension funding reform to accompany the principles I presented in testimony on April 29 before the House Education and the Workforce Subcommittee on Employer-Employee Relations. The paper is a collection of ideas and concepts that would improve the system for funding plans and enhance the DB system for the benefit of all stakeholders.

Addressing other issues presented in that same testimony, the council is currently working on developing individual issue briefs on phased employment, DB plan conversions, changing the retirement age, the relative value of savings vehicles, the yield curve, multiemployer funding reform, and lump sums and annuities.

At the Academy’s August Leadership Meeting, volunteers identified a new avenue for expanding our outreach on retirement issues. Through consumer guides, we could highlight for the public the financial efficiencies of DB plans over defined contribution plans. Armed with a better understanding of the alternatives between self-annuitization of accumulated savings and the pooling of risk that is fundamental to DB plans, employees may demand that greater portions of their benefit package be in the form of a DB plan.

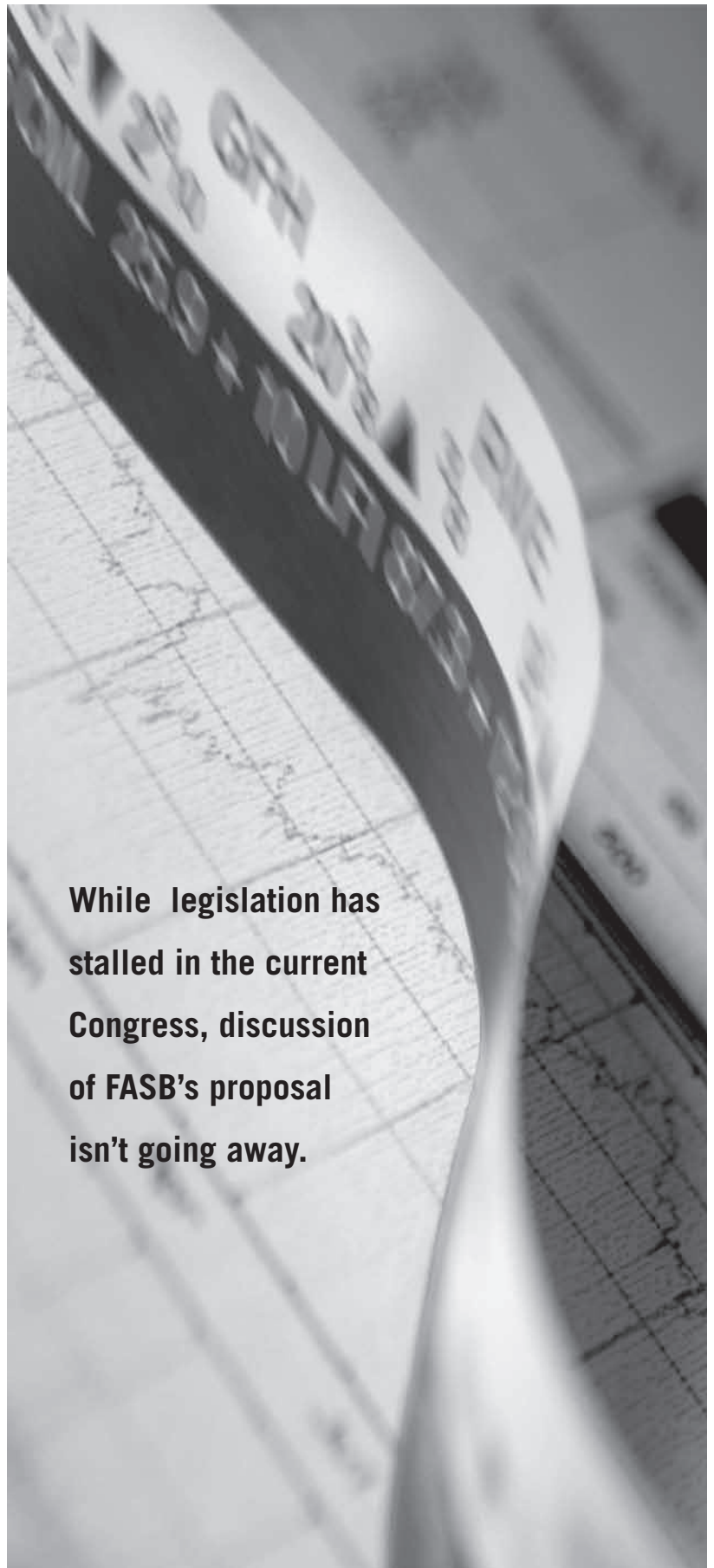
This is just a summary of the continuing efforts of the Academy staff, Academy Senior Pension Fellow Ron Gebhardtshauer, and an army of volunteer professionals who are working hard to get out the word on DB plans. We can always use more help. I invite you and your colleagues, as well as other readers of the *EAR*, to contact Heather Jerbi, the Academy’s pension policy analyst (jerbi@actuary.org; 202-785-7869).

Academy Task Force Tackles Stock Option Valuation

ON JULY 20, the U.S. House passed legislation blocking a proposal by the Financial Accounting Standards Board (FASB) that would require companies to account for stock options as an expense. The FASB-proposed statement, issued in March, would replace the traditional equation-based method for measuring the value of stock options with a valuation-based methodology. The House bill (H.R. 3574) has now gone to the Senate for consideration and is unlikely to move forward in the current session. But discussion of FASB's proposal isn't going away.

Anticipating the debate, the Academy in June created a Stock Options Task Force to examine the application of actuarial science to the valuation of stock options. Already, task force members have met with FASB staff and participated in FASB public roundtables to comment on the issue. In September, task force members will be meeting with representatives of the Securities and Exchange Commission (SEC) to discuss actuarial methods and principles that lend themselves to the valuation of stock options. The task force is also helping in the development of two sessions at the Academy's October annual meeting in Hawaii in conjunction with the Conference of Consulting Actuaries. Session 33A, "Stock Options 101: Everything You Ever Wanted to Know About Stock Options," will provide a basic overview of stock options and draw parallels to existing actuarial projects such as pension valuations. Session 57A, "Stock Options 102: Stock Option Pricing Models," will offer a more detailed look at the modeling techniques, key assumptions, and resulting sensitivities.

The House legislation, which was approved by a 312-to-111 vote, would prevent the SEC from approving any stock options expensing requirements enacted by FASB and delay the rule for a year while the Departments of Commerce and Labor study its potential economic effect. Instead, the legislation would require companies to expense only those options granted to their five highest-paid executives. Small businesses would be exempt from the bill, and newly formed public companies could delay expensing for their top executives for three years. The bill would also require that any pricing model used to determine the fair value of an option assume that the volatility of the underlying stock will be zero. During consideration of the bill, several amendments offered by opponents were defeated, including amendments to assert FASB's independence, confirm the SEC's oversight of the issue, and require that the option valuation formula prescribed in the legislation include volatility as a factor. ▲



While legislation has stalled in the current Congress, discussion of FASB's proposal isn't going away.

Limits on Benefits in Qualified Plans

BY JAMES TURPIN

WHILE MOST ACTUARIES ARE FAMILIAR with some of the current limitations on retirement plan benefits and contributions, many don't remember the roller-coaster effect that has plagued these limitations over the last 30 years. The initial post-ERISA requirements allowed a maximum benefit of \$75,000 per year as a life annuity beginning at age 55. Over the next seven years, fueled by high inflation, \$75,000 quickly rose to \$136,425. Then, overnight, the limit descended to \$90,000 per year, payable at age 62, not age 55.

For five years, the limit remained at \$90,000 before it began to gradually increase. Unfortunately, the rules changed again in 1986 while the benefit was still at \$90,000, and the limit was no longer based on payment beginning at age 62 but was instead pegged to the Social Security normal retirement age of 65 to 67. It took seven years for the limit to almost reach \$120,000, but then the rules were adjusted again so that the limitation would now increase in \$5,000 increments. Finally in 2002, the law changed yet again, but for the better, so that the new limitation was \$160,000 per year now payable at age 62 to 65, rather than at Social Security normal retirement age.

The fate of the maximum annual addition for defined contribution plans was even worse. After starting at \$25,000 in 1975, it increased to over \$45,000 by 1982, only to be stuck at \$30,000 for the next 18 years. It is now finally over \$40,000 again for the first time since 1981.

This history lesson reflects only two

of the more than a dozen limitations that affect the benefits or contributions in qualified plans. Others include the highest three-year-average compensation, annual compensation, post-retirement cost-of-living changes, the definitions of highly compensated employees and key employees, minimum benefits or contributions for top-heavy plans, gateway requirements for individual plans or combinations of plans that use cross-testing to satisfy the nondiscrimination tests, permitted disparity, lump sum distributions to the 25 highest-compen-



James Turpin, center, confers with fellow panelists Kenneth Steiner and David Godofsky at the EA meeting.

Understanding the interrelationships between various limits on retirement plan benefits and contributions is important in designing and maintaining plans that seek to maximize the utilization of these limitations.

sated employees, 401(a)(9) minimum distributions, actuarial equivalence, and the 417(e) rates.

The primary problem with applying the myriad of limitations lies in the inconsistent relationships that sometimes exist between the various limits. For example, in 2002 and 2003 the 401(a)(17) maximum annual compensation was \$200,000. However, the benefit limitation based on the highest three-year-average compensation is not affected by 401(a)(17). So a participant with \$500,000 in compensation one year, and \$20,000 in annual

compensation for another nine years, could still have the maximum dollar benefit of \$160,000, as long as the benefit formula was at least 200 percent $[200,000 + 20,000 + 20,000] / 3 * 200\% = \$160,000$. Understanding the interrelationships between the various limits is important in designing and maintaining plans that seek to maximize the utilization of these limitations.

JAMES TURPIN, a consulting actuary for the Turpin Consulting Group, is a former Academy vice president for pension issues

Correction: In James Turpin's article "Actuarial Communication: Misleading or Just Plain Confusing?" which ran in the Summer 2004 *EAR*, an editing error altered the meaning of a sentence in the first paragraph on Page 7. The sentence should read "To tell a participant that the values of the options are approximately equivalent when they have difference in value of as much as 45 percent would be misleading."

Relative Value Regs Delayed

This article was originally published as an Academy Alert in July. Academy Alerts are published as an information service to subscribers who buy annual paid subscriptions. For more information, contact Eric Opanga, the Academy's legislative assistant (opanga@actuary.org; 202-223-8196).

THE TREASURY DEPARTMENT AND THE IRS announced on June 30 that they would delay the effective date of relative value regulations for retirement plans.

The IRS published final regulations regarding disclosure requirements relat-

ing to qualified joint and survivor (QJSA) explanations on Dec. 17, 2003. The regulations require plan sponsors to provide participants receiving qualified retirement plan distributions with the relative value and financial effect of optional forms of benefits. The final regulations were generally effective for QJSA explanations relating to distributions with annuity starting dates beginning on or after Oct. 1.

The regulation will now be generally effective for QJSA explanations relating to distributions with annuity starting dates beginning on or after Feb. 1, 2006. In the interim, plans that do not comply with

the final regulations will be required to comply with prior guidance on disclosure rules. The Oct. 1, 2004 effective date of the regulation will be retained for explanations relating to any optional form subject to Section 417(e)(3) of the code (e.g., partial and full lump sums and installment payment options) if its actuarial present value is less than the present value of the QJSA, as determined by Section 417(e)(3) of the Internal Revenue Code.

Announcement 2004-58 also notes that the Treasury Department and the IRS intend to issue regulations, effective retroactively, clarifying that a plan will

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information contained in audited financial statements by requiring attestations to that effect by certain corporate executives, including statements that proper controls are in place for data derived from sources outside the control of the auditor.

This information isn't new to many readers, yet actuaries who provide employee-benefit-plan services have been surprised when they are contacted by their clients who are attempting to identify the controls in place for work performed and included in audited financial statements.

IMPLICATIONS FOR PENSION AND OPEB ACTUARIES

For companies registered with the Securities and Exchange Commission (SEC), Section 404 of Sarbanes-Oxley essentially requires

- ▶ That corporate management establish a structure to control the information provided in its financial statements
- ▶ That corporate management assess the effectiveness of its internal control structure
- ▶ That an SEC-registered public accounting firm evaluate and attest to the effectiveness of the internal control structure surrounding the development of information included in the corporation's financial statements.

For many registrants, the requirements are effective for the fiscal year that ends after Nov. 15, 2004. For smaller companies and those with only registered debt, the requirements become effective as of the fiscal year ending after July 15, 2005.

Of particular interest to actuaries who perform employee

benefit valuations for SEC-registered clients is the requirement that corporate management take responsibility for the controls placed on information in the financial statements' pension and other post-employment benefit (OPEB) footnotes. For corporate management to be able to make a formal attestation, executives must understand and be able to document the processes by which pension and OPEB results are developed. Consequently, clients are contacting actuaries in order to gain a better understanding of the controls that are in place for performing actuarial valuations, including the annual setting of assumptions.

Typical questions that arise for pension and OPEB actuaries during these assessments include the following:

- ▶ ***Has your firm received a SAS 70 letter for your valuation process?***

SAS 70, more formally Statement of Auditing Standards No. 70, identifies the factors that an auditing firm should consider when a corporation uses a third-party service organization to handle certain transactions. When appropriate, an auditing firm can audit a service organization's risk controls and provide a letter that can be furnished to those auditing the service organization's clients. This allows the process of the service organization to be audited once. A SAS 70 report isn't essential and is only provided in situations where there is a single process applied to a large group of clients; for example, defined-contribution record keeping. Such situations are distinct from the actuarial valuation model, which consists of a number of subprocesses customized to each plan's specifications. Accordingly, the ac-

not fail to satisfy the most valuable benefit requirement merely because certain present value calculations cause an optional form of benefit to be more valuable than the QJSA.

Treasury said it extended the effective date in response to concerns from a number of commentators about the need of plan sponsors to complete an extensive review and analysis of optional forms of benefits so they can adequately compare the relative value of those forms. The comments noted that proposed 411(d)(6) regulations would eliminate certain optional forms of benefit and that many

plan sponsors would effectively conduct a thorough review of all optional forms of benefit under their plans following publication of the final regulations. The commentators contended it would be more efficient for plan sponsors to conduct a single analysis of optional forms rather than two successive extensive analyses.

On May 20, the Academy sent a letter to Sen. Tom Harkin (D-Iowa) asking for his support in encouraging Treasury to delay the regulations and suggesting the implementation of an alternative approach in disclosing information to plan participants. On June 8, Sen. Harkin sent a letter

to Treasury urging it to allow the regulations to go into effect only for lump sum or non-annuity distributions and some time later for other optional forms.

Copies of Treasury's press release and Announcement 2004-58 may be obtained through Treasury's website (www.treas.gov/press/releases/js1762.htm). Copies of the Academy's letter to Sen. Harkin may be obtained through the Academy's website (www.actuary.org/pdf/pension/treasury_052504.pdf). Copies of Sen. Harkin's letter to Treasury may be obtained by contacting Eric Opanga, legislative assistant, by e-mail (opanga@actuary.org). ▲

tuary should discuss the ultimate value of any SAS 70 report before attempting to obtain one.

► **What is the process for developing and selecting actuarial assumptions?**

Corporate management is required to identify and document the controls around the selection of the assumptions used for footnote disclosures. Although Actuarial Standards of Practice No. 27, *Selection of Economic Assumptions for Measuring Pension Obligations*, and No. 35, *Selection of Demographic and Other Noneconomic Assumptions for Measuring Pension Obligations*, indicate that the assumptions used in the footnote disclosure are prescribed assumptions, the employer will be interested in documenting the process and the controls around the actuary's work to the extent that an actuary helps the client develop those assumptions.

► **What tests, cross-checks, and edits does the actuary perform on the census data?**

This question may receive a broad spectrum of responses. The process of gathering census data begins with the client. Thus, any response here likely will be considered in connection with other checks performed by another party.

► **What are your quality-review or quality-assurance processes?**

For corporate managers to attest that controls surrounding the development of the numbers are sufficient, they will want to understand the manner in which information has been checked and reviewed. They likely will want to have a brief description of all of the quality assurance steps that are undertaken.

► **What role does the actuary play in developing information for the financial statements?**

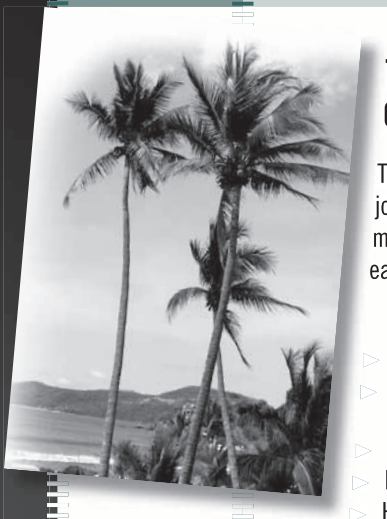
There are different services an actuary may provide for a particular client. For example, an actuary might be responsible for tracking information that helps determine whether a special event, such as a settlement or curtailment, has occurred during the year; or he or she might have a role in designing procedures to ensure that the valuation is based on the most recent plan document.

WHAT SHOULD PENSION AND OPEB ACTUARIES DO?

When actuaries are questioned along these stated lines, they should keep in mind that corporate management is seeking answers so as to attest that the controls surrounding the development of financial statement data are sufficient. From this perspective, the cooperation of the actuary is essential to resolving any issues quickly. An actuarial client's corporate management will certainly appreciate the actuary who can help to resolve this small part of a much greater process.

The requirements under Sarbanes-Oxley are new to everyone involved. Over the course of the coming year or two, chief executive and financial officers, auditors, specialists such as actuaries, and other professionals involved in the implementation of the law's requirements will have to work through the details of proper documentation for compliance. Along the way, various professional organizations, such as the American Institute of Certified Public Accountants, and the SEC may provide new guidance to help all parties comply. In the meantime, every actuary should do the best professional job possible in completing this documentation and responding to information requests in a timely manner. ▲

EARN CONTINUING EDUCATION CREDITS IN PARADISE!



This year the Academy's annual meeting will be part of the Conference of Consulting Actuaries meeting, Oct. 17-20, on the Big Island of Hawaii.

The Hawaii meeting marks the beginning of a new era of partnership, with the Academy and the CCA jointly developing and sponsoring a single annual meeting. The result: a richer program that offers you more options. The meeting features more than 65 sessions over 3½ days, and enrolled actuaries can earn up to 18 CE credit hours. Among session topics of particular interest to EAs:

- ▷ A second look at the Gray Book
- ▷ Retirement income sources and needs in the 21st century
- ▷ Barriers to bonds
- ▷ Issues regarding defined contribution plans
- ▷ How actuaries assist auditors in connection with financial statements
- ▷ Retirement plan design: an employer's perspective
- ▷ A plaintiff's view of benefit litigation
- ▷ New age-data analysis
- ▷ FAS 106—assumption, prefunding, and Medicare reform issues
- ▷ Investment options for underfunded frozen plans
- ▷ The changing view of pensions from analysts and rating agencies
- ▷ Dialogue with the IRS
- ▷ Financial economics
- ▷ Workshop on public employee retirement systems
- ▷ FAS 87 double talk
- ▷ Age discrimination versus cash balance plans on the front pages
- ▷ Pension funding reform proposals
- ▷ Enterprise risk management
- ▷ An analyst's view of financial disclosure
- ▷ Creative plan design
- ▷ GASB OPEB
- ▷ Plan fiduciary
- ▷ Return assumptions—economic vs. practice
- ▷ International retirement benefits

The keynote address for the Academy's annual meeting luncheon on Monday, Oct. 18 will be Sen. Don Nickles, chairman of the powerful Budget Committee. The luncheon will also feature the installation of Robert Wilcox as the Academy's new president and the presentation of the Jarvis Farley Service Award.

Academy and CCA members pay the same low fee and qualify for airline, car, and hotel discounts. The Fairmount Orchid resort on the breathtaking Kohala Coast of Hawaii features golf, tennis, snorkeling, luaus, excursions, and an outdoor spa.

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