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ENROLLED ACTUARIES REPORT

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Questions for the IRS

Editor's Note: The following is the full text of a letter the Academy recently sent to the Internal Revenue Service seeking guidance on Circular 230 revisions that are due to become effective at the end of June.

May 9, 2005

The Office of the Secretary of the Treasury
c/o Ms. Heather Dostaler
Office of the Associate Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Dear Sir or Madam:

On behalf of the members of the American Academy of Actuaries Pension Committee, I would like to take this opportunity to comment on the recently finalized revisions to Circular 230, which raise questions among pension actuaries regarding how Sections 10.33 and 10.35-10.37 apply to their work. In particular, committee members are concerned over the extent to which a pension actuary's work product may constitute a "covered opinion." Mr. Edward E. Burrows, a member of our committee, spoke recently over the telephone with Ms. Heather Dostaler of the office of the Associate Chief Counsel of the Internal Revenue Service (IRS) about QUESTIONS FOR THE IRS, PAGE 2

From left, Steve Goss, Tom Terry, and Harlan Weller confer at the 2005 EA meeting. For coverage of the meeting, turn to Page 4.

Inside this issue

JAMES TURPIN

Enrolled Actuaries and Circular 230

FOR THOSE ENROLLED actuaries who are not directly involved with applications for determination letters or with representing clients in Internal Revenue Service (IRS) examinations, there is a tendency to forget that part of being "enrolled" means following the rules for practicing before the IRS. Enrolled actuaries are subject to the IRS practice requirements that apply to attorneys, accountants, and enrolled agents. As the letter that the Academy's Pension Committee recently sent to the IRS attests (see above), enrolled actuaries are required to follow the rules in Circular 230.

The IRS says that the recent changes to Circular 230, which prompted the Academy's request for clarification, are an outgrowth of a number of ethical lapses by tax professionals in the past 10 to 15 years. While the IRS seems to be most concerned about legal or accounting opinions regarding the tax treatment of certain transactions, many of which may lack adequate basis for their conclusions, the IRS goal is to rein in those practitioners who are violating the rules and to improve professional practices overall.

As professionals, we create value by providing our clients with proper advice and technical assistance. However, when do our efforts cross the line and shift from interpreting the rules to providing a blueprint solely designed to avoid taxes? The answer isn't clear, nor is it necessarily unprofessional

EAs AND CIRCULAR 230, PAGE 3

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ENROLLED ACTUARIES REPORT

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some of the profession's concerns.

Ms. Dostaler suggested that a certain number of the committee's questions would require some thought before receiving a detailed response. The purpose of this letter is to confirm our understanding of the responses Ms. Dostaler offered, and provide a list of those questions for which she indicated more consideration would be required.

Impact of the Qualified Plan Exception

We note written advice that "[c]oncerns the qualification of a qualified plan" would not constitute a covered opinion.

As a threshold issue, we understand that this exception applies to advice regarding the qualification status of a plan *that the practitioner believes to be qualified*, even if it is later determined that the plan was not qualified. Ms. Dostaler confirmed that this understanding is correct.

Additionally, we would appreciate confirmation that the establishment or maintenance of a qualified retirement plan is never a transaction, "the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code (IRC)."

With respect to this second threshold issue, one must examine the principal purpose of establishing any qualified plan. One could argue that most of the benefits of a qualified plan, other than favorable tax treatment, could be obtained by a plan that does not satisfy qualified plan rules. Thus, according to this reasoning, the principal purpose of establishing that the plan is qualified is to avoid or postpone taxes—for the plan sponsor, for participants, or for invested assets. However, we believe that contention misses the mark. The primary reason for the provision of pensions to most participants is to provide them with the financial ability to retire. Policy-makers have supported that objective by providing tax incentives to do so. The wording of Subparagraph 10.35(b)(2)(ii)(B)(1) (the exception) suggests that in at least some cases the drafters agree that the principal purpose of a qualified plan is not tax avoidance. We believe that if, in general, the principal purpose of a qualified plan is not tax avoidance or evasion, then the principal purpose of *any* qualified plan is not tax avoidance or evasion. We seek guidance as to whether you agree and, if not, what criteria should be used to differentiate.

Activities that Appear to Be Covered by the Exception

A number of activities appear to be covered by the exception for qualified plans. However, we feel we need confirmation that they are, indeed, covered. These activities covered by the exception include written communications regarding:

- The rules governing the extent to which the use of insurance company contracts and various other investments will adversely affect a plan's qualified status.
- The rules governing the extent to which honoring a judicial domestic relations order will adversely affect a plan's qualified status.
- The rules respecting benefit distributions and rollovers that must be followed in order to avoid adversely affecting a plan's qualified status.
- Nondiscrimination testing under IRC Sections 410(b) and 401(a)(4).
- Any rule whose incorrect application would cause an otherwise qualified plan to lose its qualified status.

Unaddressed Activities That Would Logically Be Covered by the Exception

Another important issue involves other written results and advice pension actuaries often provide in the normal course of their activities. Often, this information has nothing to do with conclusions regarding a plan's qualification status. Rather, this information is typically related to maintaining a plan's compliance with ERISA and various tax-related laws of the sort found in the following list:

- The rules for calculating minimum funding requirements.
- The rules for calculating maximum deductible contributions.
- The rules for calculating excise taxes and similar miscellaneous taxes incidental to the establishment, administration, and termination of qualified plans.
- The rules for determining the extent to which plan participant loans are taxable as current distributions.
- The tax rules related to group life insurance, uninsured health plans, cafeteria plans, fringe benefit arrangements, dependent care plans, cash or deferred arrangements embedded in qualified plans, non-qualified deferred benefits, VEBAs,

ESOP loans, and other compensation and benefits issues.

➔ The rules for determining whether distributions constitute a series of substantially equal payments for the purposes of Code §72(q) and similar sections.

➔ The timing and content rules of reporting and disclosure requirements related to qualified plans and the other employee benefit plans we have mentioned.

In the balance of this letter, we discuss some of the pension actuary's work involving the items we have listed. We seek guidance as to whether written advice related to this work constitutes "written opinions."

Inability of Most Actuaries to Practice Law

Pension actuaries, who are not attorneys, are not authorized to practice law. Even those few actuaries who are licensed attorneys are generally functioning as employees of firms that are not law firms and thus do not practice law. Consequently, pension actuaries do not opine on interpretation of tax law.

Our primary activity related to the items we have listed involves making calculations and measurements based on our understanding of the law. In order to perform this activity, we must be broadly familiar with applicable legal concepts. For clarity, our written advice often discusses these concepts in addition to communicating the results of our computations. These discussions may touch on areas where attorneys differ in their views. However, this does not alter the fact that a pension actuary's responsibility is not to render opinions respecting application of tax laws. Instead, it is to make those calculations that must be made in order to apply these laws.

For this reason, if for no other, we do not believe performing computations related to any item on our lists—and communicating, in writing, the results of these computations—constitutes the rendering of a covered opinion. We seek guidance as to whether you agree. Ms. Dostaler indicated that this was a good question but one on which she would be unable to offer a response without further consideration.

We do acknowledge that our clients often expect to rely on our calculations for their tax purposes. For example, we would not expect to tell a client that our calculation of the amount to be contributed and deducted could not be used for the purpose of avoiding penalties that may be imposed in the event of a challenge. Nevertheless, we see a significant distinction between this form of reliance and reliance on a covered opinion. To a great extent, our clients' reliance is simply reliance on the accuracy of our mathematical calculations and the exercise of our professional judgment in selecting actuarial assumptions—an exercise that is required by tax law.

Other Activities of Pension Actuaries and Their Associates

In addition to the activities this letter has already described, plan actuaries often become involved in day-to-day plan administration. It seems clear to us that such administrative activities do not approach the level of preparing covered opinions.

We also find ourselves drafting provisions for inclusion in plan and related documents. However, these provisions typically include the warning that only an attorney acting in the role of a practicing attorney can opine on the appropriateness of such document language.

Limits on Enrolled Actuaries' Authority to Practice Before IRS

An enrolled actuary's authorization to practice before the IRS is limited to well-defined sections of Title 26 of the United States Code. Many of the activities we have listed fall outside this welldefined authorization. We QUESTIONS FOR THE IRS, PAGE 8

EAs AND CIRCULAR 230, FROM PAGE 1

to assist your client in avoiding taxes. After all, if a contribution to a retirement plan represents a deductible expense to the employer, is it inappropriate to design a plan with a greater benefit that will require a higher contribution, which in turn produces a larger deduction for tax purposes? Probably not, but a practitioner who takes the additional step of showing a client how to evade taxes can trigger severe consequences for both the client and the professional.

It doesn't appear that the IRS intends for routine correspondence on plan qualification among actuaries, plan sponsors, and other advisers to be an issue under the revised rules. In other areas, such as opinions about the deductibility of contributions, it's not as clear what is required by the new rules. Thus, all enrolled actuaries need to be familiar with Circular 230 and need to exercise caution when providing written advice that affects the taxation of a client.

Finally, written opinions exist only as long as someone can still read them. Depending on the content, e-mail may be a written opinion and constitute an actuarial communication. So, as a reminder, if you send an opinion by e-mail, it may be accessible in cyberspace for a lot longer than you ever intended.

JAMES TURPIN, *a former Academy vice president for pension issues, is a consulting actuary for the Turpin Consulting Group in Albuquerque, N.M.*

30th Annual Enrolled

BRUCE GAFFNEY

RASD and Relative Value

SESSIONS 201 AND 601 of the 2005 Enrolled Actuaries meeting provided a comprehensive review of the regulations on retroactive annuity starting dates and relative value disclosure, as well as an in-depth discussion of some of the outstanding issues and unanswered questions with respect to these rules.

The regulations on retroactive annuity starting dates provide administrative parameters for the retroactive commencement of benefits. A "retroactive annuity starting date," as defined in the regulations, falls before the date the required qualified joint and survivor annuity (QJSA) notice is provided to the participant. The Economic Growth and Tax Relief Reconciliation Act of 2001 amended the Internal Revenue Code to allow retroactive annuity starting dates; regulations (released in 2003) provided rules on how a retroactive benefit start should be administered and specified that a plan must explicitly allow for retroactive start dates and that appropriate interest must be provided on late payments to a participant.

The regulations on disclosure of the relative value of optional forms of payment endeavor to keep rules and procedures consistent (i.e., an "apples to apples" comparison) so participants will have a better understanding of the differing value of various possible payment forms. (The Academy recently commented to the Internal Revenue Service on these regulations. See story on Page 5.)

Each regulation was reviewed in depth in Session 201. Panelists discussed the application of each set of rules, highlighted points at which an actuary or plan sponsor must make decisions ("Will retroactive annuity starting dates be offered?" or "What rate of interest must be used to calculate makeup payments?"), and provided examples.

In Session 601, the panelists provided a brief review of the rules, including an explanation of the complicated two-step process to determine whether the delayed effective date for relative value disclosure applies for certain optional forms of payment. There was a discussion of the interaction of and coordination between the relative value disclosure rules and the retroactive annuity starting date rules.

The session then explored some of the gray areas in these relatively new regulations, including:

➔ What is the best way to coordinate retroactive annuity starting dates with mandatory benefit start dates? Many plans specify that payment must commence at age 65 if the participant is not actively employed at that time. Frequently, participants terminate employment before age 65 but cannot be located when they turn 65. When a participant is found at an age older than 65, what payment options should be made available? Should payment begin retroactively to age 65? What if the plan does not provide for retroactive annuity starting dates?

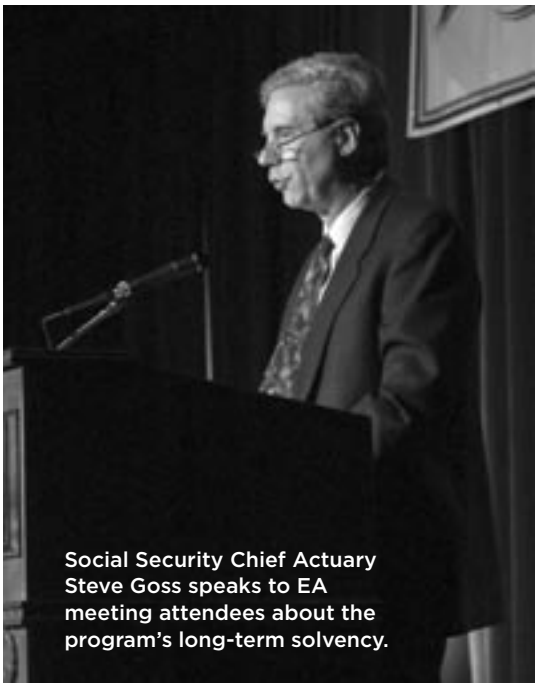
➔ What is an appropriate interest rate when providing retroactive makeup payments? Does the answer differ if the plan in question is a cash balance design? Does the length of the retroactive period matter?

➔ What are reasonable assumptions (a common question in other areas of actuarial practice) when

Mark Warshawsky, assistant Treasury secretary for economic policy, discusses the Bush administration's pension reform proposal at the EA meeting's third general session.

Actuaries Meeting

More from the meeting on Pages 6 & 7



Social Security Chief Actuary Steve Goss speaks to EA meeting attendees about the program's long-term solvency.

actually calculating relative values?

➔ The relative value of all optional forms that are generally available must be disclosed. What does generally available mean? Does the answer differ depending upon the size of the plan population or upon the frequency with which a form of payment is elected?

➔ Precept 8 of the Code of Professional Conduct requires that the actuary take reasonable steps to ensure that his or her services are not used to mislead other parties, while Precept 1 requires the actuary to act with honesty and integrity and to uphold the profession's reputation. Are either—or both—of these precepts violated when optional forms of payment with substantially different values are disclosed as equivalent in value, as is sometimes permissible? For example, in certain instances, any optional form of benefit that has a value of at least 95 percent of the value of the QJSA may be disclosed as equivalent in value to the QJSA. Hence, two forms of payment—one worth the same as the QJSA and the other worth 50 percent more than the QJSA—can be disclosed as equal in value. Is the actuary who makes this disclosure violating Precept 1 or Precept 8?

BRUCE GAFFNEY *is a principal and consulting actuary in the Benefits Consulting Group at Ropes & Gray in Boston.*

RELATIVE VALUE REGS: A FEW GOOD SUGGESTIONS

ON MAY 10, the Academy's Pension Committee sent a letter to the Internal Revenue Service commenting on newly re-proposed regulations on disclosing relative values for optional forms of benefits under a defined benefit plan.

The Academy has two primary concerns with the proposed regulations. The first relates to the option of describing certain benefits as equal in value to a qualified joint and survivor annuity (QJSA), assuming an actuarial present value of at least 95 percent of the QJSA present value. Professional standards require actuaries to ensure that their services are not used to mislead, and the Academy is concerned that such a description may conflict with that standard. Furthermore, professional standards require the use of "reasonable assumptions," but the proposed regulations are not clear as to whether assumptions should be reasonable from a plan participant's perspective or from the plan's perspective. The Academy's letter recommended a modification of the equal-value language in the regulations to indicate that only optional forms worth between 95 and 105 percent of the QJSA be described as approximately equal. The letter also suggested that the regulations' language be clarified to indicate that assumptions must be reasonable from the plan's perspective, not individual circumstances.

The Academy's second concern is that the amount of disclosure the regulations require may be overwhelming for participants and include unnecessary detail. In its letter, the Academy suggested clarifying or simplifying certain information requirements, including disclosures for open option plans, retroactive annuity starting dates, and separately determined portions of benefits under the plan.

In addition to these two primary concerns, the letter addressed a number of technical issues, including payment of qualified pre-retirement survivor annuity, combining of grouping rules, and annuitization of money purchase assets through defined benefit plans.

Edward Burrows, Marge Martin, John Moore, and Donald Segal participated in the drafting of the letter.

—HEATHER JERBI

30th Annual Enrolled

Sarbanes-Oxley and the Enrolled Actuary

EDITOR'S NOTE: *Mark Beilke died unexpectedly on May 1 at the age of 50, just weeks after speaking at the Enrolled Actuaries meeting session on Sarbanes-Oxley. Beilke was director of employee benefits research for Milliman in Vienna, Va., and an active member of the Academy, serving as chairperson of the Pension Accounting Committee and as a member of both the Pension Practice and the Risk Management and Financial Reporting Councils. He will be missed.*

MARK BEILKE, chairperson of the Academy's Pension Accounting Committee, and Carrie Duarte, a member of the Academy's Stock Options Task Force, discussed the impact of the Sarbanes-Oxley Act on pension actuaries at a packed session at the recent Enrolled Actuaries meeting.

In his overview of the legislation, Beilke touched on several elements but spent most of his time discussing the implications of Section 404, which requires attestations by an entity's CEO, CFO, and auditor as to the adequacy and scope of internal controls for financial reporting. Beilke distinguished 404 attestations, which focus on how financial reporting numbers are generated, from the audit, which focuses on what the numbers are and whether they are correct. Error-free financial reporting outcomes do not necessarily guarantee the adequacy of the internal controls governing the process that developed those outcomes.

Discussing the specifics of assessing internal controls, Duarte divided the control requirements into four main areas:

- Mitigating the possibility of a financial restatement
- Providing for the security of assets
- Providing for approval over transactions
- Providing for record retention.

Duarte also outlined a generic documentation and testing process for complying with Section 404 requirements.

Duarte then discussed the scope and variations of SAS 70 documents, which are single audit reports provided by a service organization to its clients' auditors so that each of those auditors doesn't need to conduct his or her own review of the organization's controls.

Finally, Beilke and Duarte highlighted the potential impact of Sarbanes-Oxley requirements on pension actuaries. They said that clients might ask for documentation of actuarial credentials as part of the valuation process or require documentation of consistent criteria for using various inputs and data used to select assumptions.

—ETHAN SONNICHSEN

Joint Board Considers Changing the Rules

REGULATIONS GOVERNING enrolled actuaries are currently being considered for revision. But don't expect changes anytime soon.

"This will not be a speedy process—it will not be glacial, but it will not be speedy," said Martin Pippins, former chairperson of the Joint Board for the Enrollment of Actuaries and current manager of technical guidance and quality assurance for the Internal Revenue Service. "Remember that it's been 25 years since the last final regulation. It could be another 20 to 25 years before the next regulation comes out. These will be the rules to govern enrolled actuaries for the next generation, so we want to get it right."

Pippins spoke at a session on the joint board at the recent Enrolled Actuaries meeting. Joining him were Pat McDonough and Rudy Nuissl, respectively the joint board's executive director and its current chairperson.

In June 2004, the joint board solicited ideas from the public about possible areas for revision. By the September deadline, it had received comments from all the major actuarial organizations, as well as from several consulting firms and individual actuaries, Nuissl said.

Nuissl cited five broad areas of concern that were mentioned by those who commented:

- Procedures and conditions for enrollment and renewal of enrollment
- Continuing professional education (CPE) requirements
- The waiver system for CPE
- Types of enrollment status, particularly inactive status
- Standards of conduct, performance, and practice governing the actuarial profession.

One area of universal agreement in the comments, Nuissl said, was the suggestion that the joint board focus on the utilization of new technology in the delivery and auditing of CPE and the storage of CPE records by actuaries.

Actuaries Meeting

Stock Option Valuation

AS THE TREATMENT OF STOCK OPTIONS and how they are valued come under greater scrutiny, actuaries have found an emerging area of practice that utilizes a number of skills that are prevalent in the profession. The session on stock option valuation at the recent Enrolled Actuaries meeting provided actuaries with an understanding of:

➔ The reasons actuaries should be involved in stock option valuations

➔ The various models that could be applied to such valuations

➔ Demographic and other assumptions that must be considered when choosing the appropriate methodology.

Terry Adamson, a vice president at Aon Consulting in Philadelphia, and Scott Turner, a consulting actuary at Watson Wyatt in New York, discussed some of the differences between closed-form models for valuing stock options (Black-Scholes) and open-form models (binomial models, often referred to as lattice models). Using examples of each model type, the two demonstrated that open-form models tend to be more transparent. Open-form models are also more flexible because of their ability to vary assumptions for different measuring periods. With a Black-Scholes model, for instance, exercise behavior is modeled at a single point in time; a lattice model provides a distribution of exercise behavior. However, the same model may not be applicable to all companies because of different current and historical data. It is therefore important to consider all factors relevant to a particular company when developing a specific method and assumptions.

The actuarial profession's increased interest and involvement in this area of practice has resulted in the creation of the Academy's Stock Options Task Force, which is currently developing a practice note on the valuation of stock options.

—HEATHER JERBI

BRUCE GAFFNEY

The 2005 Gray Book

IN WHAT HAS BECOME AN ANNUAL EVENT, actuaries post technical questions for answer by certain Treasury Department and Internal Revenue Service (IRS) staff. Their responses, summarized and published for the Enrolled Actuaries meeting as the Gray Book, aren't formal guidance but can be helpful to actuaries facing the many unanswered questions that arise in our practice.

The 2005 Gray Book contains 42 questions on topics such as defined benefit plan funding, Internal Revenue Code Section 415, relative value disclosure, retroactive annuity starting dates, and automatic rollovers. In a session at the recent EA meeting, panelists reviewed a number of these questions, highlighting responses that were interesting or unexpected.

The subtleties of relative value disclosure rules are addressed in a number of Gray Book questions. The panelists discussed the application of the relative value disclosure rules using participant-specific information for some options and generally applicable information for other options, the assumptions used in calculating relative values, and disclosure for complex or variable benefit options. Questions on various aspects of compliance with the retroactive annuity starting date regulations were also reviewed.

The panelists also explored how current liability and plan assets are calculated for purposes of determining the applicability of rules under Section 1.401(a)(4)-5 of IRS regulations on restricted distributions to certain highly compensated employees. The Gray Book's response to the multi-part question addresses the timing of the determinations, whether receivable contributions can be reflected (they can't), and how assets are valued.

Other topics discussed included:

➔ How are receivable contributions handled when allocating assets in a spin-off situation?

➔ How is current liability determined for a plan's prior years under special rules enacted in the Pension Funding Equity Act of 2004?

➔ How is current liability determined in unusual situations, such as when a plan offers partial lump sum payments?

➔ When is an automatic approval available if a new actuary completes a valuation?

BRUCE GAFFNEY *is a principal and consulting actuary in the Benefits Consulting Group at Ropes & Gray in Boston.*

do not believe that computations and their written communication involving issues falling outside this area of authorization constitute covered opinions. We seek guidance as to whether you agree. This, too, is a question that Ms. Dostaler indicated had merit but on which she would be unable to offer a response without further consideration.

Summary

To summarize, we seek guidance on:

1. The meaning of the exception regarding the qualification of a qualified plan.
2. Treatment, in general, of tasks apparently not covered by the exception.
3. The status of the actuary not authorized to practice law.
4. Applicability of the circular to issues in areas where the enrolled actuary is not authorized to practice before the IRS.

Follow-up Guidance

If your guidance indicates that some of the normal activities of the pension actuary do involve covered opinions, we would appreciate being able to follow up with additional implementation questions.

Some of these questions will be quite mechanical, involving such rules as the placement of a caveat on a document, the requirements of type size, or any information required to be added to standard actuarial communications, such as the annual valuation report.

Others will be more substantive, such as the steps that practitioner A might need to take to control the work of practitioner B when practitioner B is a direct subordinate of practitioner A.

However, we would prefer to hold off on addressing solutions to these situations until we have a more complete understanding of the scope of the issue.

Best Practices

In our follow-up guidance request, we also expect to seek clarification of the provisions of Section 10.33 outlining "best practices." These provisions seem subject to a broad range of interpretations. For example, one observer might describe a given instance of client interaction as reflecting very clear communication. Another might describe the same instance as reflecting a significant lack of communication. Especially with a subject as complex as taxes, it will often be impossible to demonstrate that one observer is right and the other wrong.

We do understand that practitioners will not be subject to discipline by the IRS for real or perceived failure to follow the regulatory definition of "best practices." However, we have great concerns over the impact of these regulations on civil court actions. Plaintiffs' attorneys will interpret the already mentioned requirement of clear communications in the way that best serves their clients' interests. Where the regulations lend themselves to such a broad range of interpretation, it will be difficult (and expensive) for defendants to protect themselves against potential self-serving interpretations.

The inevitable result could be costly, inappropriate settlements and increased legal costs. In turn, these could lead to higher liability insurance premiums, resulting in higher fees to our members' clients. Employer-sponsored retirement plans already constitute an area beset by extremely complex rules and the high fees associated with compliance with the rules. The imposition of still higher fees could discourage the formation and maintenance of these plans.

We appreciate the opportunity to provide these comments, and we look forward to hearing from you. If you have any questions or would like to discuss this further, please contact Heather Jerbi, the Academy's senior pension policy analyst (202.785.7869; Jerbi@actuary.org).

Sincerely,

Kenneth A. Kent, MAAA, EA,
FCA, FSA
Vice President, Pension Practice Council
American Academy of Actuaries

Correction: A line was dropped at the end of the article "Academy Measures Pension Reform Options," which began on Page 1 and finished on Page 7 in the Spring *EAR*. The complete URL to read the issue analysis online is www.actuary.org/pdf/pension/funding_single.pdf.