



*Trends in Employee Plans Function  
Enforcement Activities for  
Fiscal Years 2000 - 2005*

**August 24, 2006**

**Reference Number: 2006-10-116**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

August 24, 2006

**MEMORANDUM FOR** COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES  
DIVISION

*Michael R. Phillips*

**FROM:**

Michael R. Phillips  
Deputy Inspector General for Audit

**SUBJECT:**

Final Audit Report – Trends in Employee Plans Function Enforcement  
Activities for Fiscal Years 2000 – 2005 (Audit # 200610007)

This report presents the results of our review of relevant statistical data for trends in the Employee Plans function's enforcement activities for Fiscal Years 2000 – 2005.

*Synopsis*

Changes in the way the Employee Plans function applied resources and selected returns for examination resulted in improvements to key compliance indicators. The Employee Plans function adopted a market-segment approach for identifying and selecting returns for examination and increased resources devoted to the Examination program. These initiatives were the primary reasons for improvements in key compliance indicators.

Overall, compliance activities increased and results improved during Fiscal Years 2004 and 2005, reversing a downward trend in key compliance indicators during the previous 4 fiscal years. Specifically, there were increases in the number of returns examined and amount of additional tax assessments. There was also an overall decrease in the number of returns that were selected for audit but closed without any change to the original return. In addition, the Employee Plans function reported an improvement in the quality of examinations from the early periods of our review, and Customer Satisfaction ratings were generally consistent and met established goals.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

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*Recommendations*

We made no recommendations in this report. However, key Internal Revenue Service management officials reviewed it prior to issuance and agreed with the facts and conclusions presented.

Copies of this report are also being sent to the Internal Review Service managers affected by this report. Please contact me at (202) 622-6510 if you have any questions or Nancy A. Nakamura, Acting Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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*Table of Contents*

**Background** .....Page 1

**Results of Review** .....Page 3

    Changes in the Way the Employee Plans Function Applied Resources  
    and Selected Returns for Examination Have Resulted in Improvements  
    to Key Compliance Indicators Since Fiscal Year 2003 .....Page 3

**Appendices**

    Appendix I – Detailed Objective, Scope, and Methodology .....Page 28

    Appendix II – Major Contributors to This Report .....Page 30

    Appendix III – Report Distribution List .....Page 31



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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## *Abbreviations*

AIMS	Audit Information Management System
EO TEP	Exempt Organizations Total Examination Program
EP	Employee Plans
EPTA	Employee Plans Team Audit
FTE	Full-Time Equivalent
FY	Fiscal Year
I.R.C.	Internal Revenue Code
IRS	Internal Revenue Service
LMSB	Large and Mid-Size Business
RAP	Remedial Amendment Period
RICS	Returns Inventory and Classification System
TE/GE	Tax Exempt/Government Entities
TEQMS	Total Examination Quality Measurement System
U.S.C.	United States Code



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## *Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

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### *Background*

The Employee Plans (EP) function is part of the Tax Exempt and Government Entities (TE/GE) Division that was established in Fiscal Year (FY) 2000. Within the Division, the EP function Examination operation is responsible for ensuring pension plans and the variety of employee benefit plans are in compliance with Internal Revenue Code (I.R.C.) sections and regulations. Plans meeting I.R.C. qualification standards are accorded special tax treatment under the law. This includes a current tax deduction for employers for contributions to qualified plans; for employees, the contributions are not currently included in income. If employee plans fail to meet the qualification requirements, this favorable tax treatment may be denied, meaning the employer may lose tax deductions and employees may have to report the benefits on their tax returns.

To meet its responsibility, the EP function Examination operation promotes voluntary compliance by:

- Identifying and correcting noncompliance through focused, efficient examinations.
- Ensuring consistency and fairness in the application of the law.
- Resolving issues at the lowest possible level (to allow employers to identify and correct deficiencies prior to Internal Revenue Service (IRS) adjudication).

***One of the goals of the EP function Examination operation is to promote voluntary compliance by:***

- ***Identifying and correcting noncompliance by conducting focused, efficient examinations.***
- ***Analyzing operational features of retirement plans.***

During FYs 2000 – 2005, the EP function issued annual workplans setting forth specific program priorities within its Examination operation in support of priorities described in the IRS Strategic Plan. The EP function aligned its Examination operation emphasis to be consistent with the overall goals for the IRS.

Annual workplans also included the activities and projects EP function employees would work on during the year and the types of cases that would be assigned. For example, the FY 2005 annual workplan showed the EP function Examination operation would continue work in key compliance programs such as abusive tax avoidance transactions and risk analysis of compliance levels in various market segments.

The EP function Examination operation priorities have evolved during the period included in our review. For example, with the establishment of the TE/GE Division in FY 2000, the EP function Examination operation's FYs 2000 and 2001 workplans included guidance on "research



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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programs,” described as a systematic method of defining the EP function universe by examining samples from different market segments and using the results to profile those segments. In FY 2002, the EP function Examination operation started documenting compliance baseline data from previously completed audits to assess the impact of EP function compliance efforts on three market segments. In FY 2003, the EP function Examination operation began assigning returns from four market segments for which previous examinations showed the percentage of returns having a tax change was relatively high but the number of returns examined from those segments was relatively low.

This review was performed at the TE/GE Division Headquarters in Washington, D.C., during the period December 2005 through April 2006. The audit was conducted in accordance with *Government Auditing Standards*. However, we relied on information accumulated by the IRS and maintained on IRS computer systems and did not verify its accuracy. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

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## *Results of Review*

### ***Changes in the Way the Employee Plans Function Applied Resources and Selected Returns for Examination Have Resulted in Improvements to Key Compliance Indicators Since Fiscal Year 2003***

Overall, compliance activities improved as both the number and quality of completed examinations increased during FYs 2004 and 2005, reversing a downward trend in key compliance indicators during the previous 4 fiscal years.

For example, while the total number of returns examined in FY 2005 was 31 percent below the total for FY 2000, there was a 34 percent increase in the number of examinations in comparison to FY 2003 (see Figure 4). This increase coincides with the end of the Remedial Amendment Period (RAP) in January 2004, when revenue agent resources were reassigned to address significant increases in requests for a determination letter<sup>1</sup> and inventories of in-process determination applications.<sup>2</sup>

There was a corresponding trend in total additional tax assessments. From FYs 2000 – 2003, the amount of additional tax assessed fell from a high of \$103.5 million to a low of \$1.7 million. Over the past 2 fiscal years, there have been steady increases, with a total of \$38.7 million of additional assessments for FY 2005 (see Figure 15).

The average time per examination increased in all but 1 year since FY 2000, with a 29.4 percent increase overall from FYs 2000 to 2005. Since the EP function Examination operation adopted a “market-segment” examination approach in FY 2003, time per case increased 13.5 percent, primarily due to conducting audits of more complex issues and a significant hiring initiative in FY 2005 that resulted in increased training for the less experienced staff (see Figure 8).

The number of returns for which examinations resulted in no change to tax increased overall from FYs 2000 – 2004. For example, the “no-change” rate was 59.4 percent in FY 2000, and it peaked at 73.0 percent in FY 2002. However, since the EP function Examination operation

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<sup>1</sup> Many employers desire advance assurance that the terms of their plans satisfy the requirements of the I.R.C. and will submit an application to the IRS for a determination letter. EP function specialists analyze the applications to determine if the plans are established in a manner that meets current laws and are substantially compliant with the I.R.C. and any applicable Revenue Procedures.

<sup>2</sup> The IRS allows plan sponsors a period of time, called the RAP, to incorporate tax law changes without a penalty or sanction. The end of the RAP becomes the deadline for timely filing a determination application on the changes to the plan. The most recent RAP was scheduled to end on December 31, 2001, but was extended several times to January 31, 2004.





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## *Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

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adopted a market-segment approach in FY 2003, the no-change rate dropped to 57.1 percent in FY 2005, the lowest level since FY 2000 (see Figure 12).

The following sections of this report describe the efforts of the EP function Examination operation to enforce compliance with I.R.C. provisions related to pension plans. This includes analyses of EP function enforcement and staffing data for FYs 2000 – 2005 to identify trends in the following areas:

- Resources applied to EP function enforcement. This is measured by the Full-Time Equivalents (FTE)<sup>3</sup> applied to the EP function Examination operation.
- Number of completed examinations.
- Time expended on examinations.
- Change rate. This is measured by the percentage of returns on which noncompliance is found and the plan sponsor is required to correct the pension plan to bring it into compliance with the law. Conversely, a no-change rate is the percentage of returns that were determined to be in compliance with the law and no change is proposed to the return.
- Dollars assessed as a result of examination. Because pension plan returns are nontaxable, the assessments for noncompliant plans post as a Miscellaneous Penalty on the IRS Non-Master File.<sup>4</sup> There also may be related assessments for additional income tax on individual or business returns or excise tax on employee benefit plans.
- Examination quality. This is measured by the results of quarterly quality reviews of examinations. The EP function Quality Review Staff completes the reviews.
- Customer satisfaction. This is measured by surveying customers after their examinations are completed.

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<sup>3</sup> A measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2004, 1 FTE was equal to 2,096 staff hours. For FY 2005, 1 FTE was equal to 2,088 staff hours.

<sup>4</sup> The Non-Master File supports processing of transactions not compatible with the IRS Master File processing, timeliness, or data. The Master File is the IRS database that stores various types of taxpayer account information; it includes individual, business, and employee plans and exempt organizations data.



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## *Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

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### **An increase in Determination applications resulted in fewer resources being applied to EP function Examination operation activities**

Data from the TE/GE Division Technical Time Reporting System<sup>5</sup> showed the number of FTEs applied to EP function Examination operation activities increased in FY 2004 following a significant decline in resources expended in this area from FYs 2000 – 2003. A major factor driving this trend was a decision to redirect revenue agent resources to the Determination operation to assist with a large influx of Determination applications resulting from a RAP. EP function Examination operation management made this decision to give plan sponsors good customer service on their Determination application requests. This also enabled EP function management to ensure employers had correctly amended their pension plans upfront instead of waiting to examine the corrections through the Examination operation. However, because the RAP was extended several times over a multiyear period, EP function Examination operation management had a difficult time planning the Examination operation resources and workload for each upcoming year. Their intent was to shift Examination operation resources to work Determination applications as they were needed during the year. When assigning work, EP function Examination operation managers were aware the ability to complete their regular work could be affected by the need to reassign staff to the Determinations program.

Figures 1 – 3 present the following:

- Figure 1: FTEs planned and expended by the EP function on direct Examination operation activities.<sup>6</sup>
- Figure 2: Total Determination letters issued.
- Figure 3: Total FTEs expended by the EP function on direct Examination operation activities and by the EP function overall.

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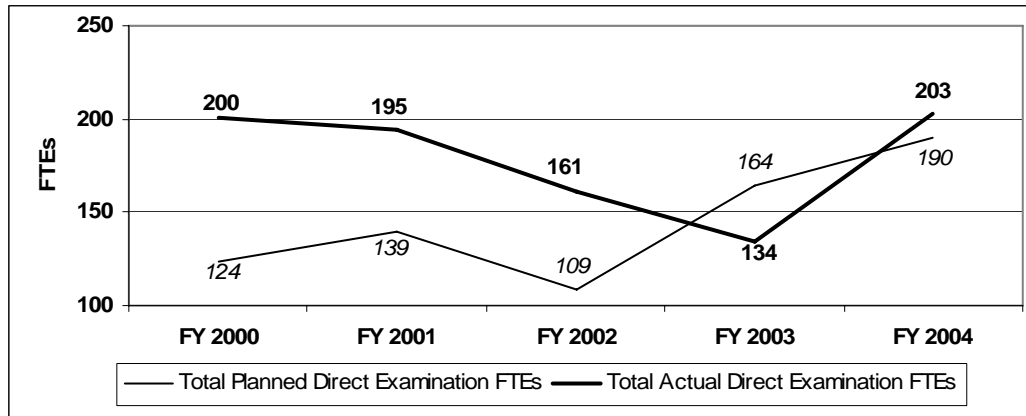
<sup>5</sup> The TE/GE Technical Time Reporting System is used to monitor time planned for and applied by employees in TE/GE Business Segments.

<sup>6</sup> Direct Examination activity – Time expended to conduct an audit of a return.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

**Figure 1: Total FTEs Planned and Expended by the EP Function on  
Direct Examination Activities (FYs 2000 – 2004)**



*Source: EP function Technical Time Report 11 for FYs 2000 – 2004. Actual FTEs for FY 2005 were not readily available due to issues with implementation of a new management information system.*

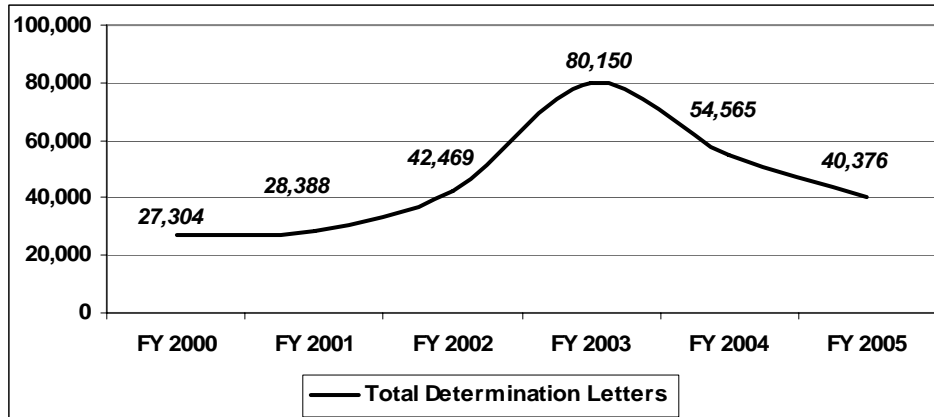
During the early periods shown in Figure 1, there were sizeable differences in total planned and actual direct Examination operation FTEs. The differences were attributable primarily to the anticipated need for revenue agent resources to assist with the processing of Determination applications that did not materialize until FY 2003.

The expected rise in Determination applications started in the spring of FY 2002. As shown in Figure 2, the number of Determination letters issued in reply to these applications reached its peak in FY 2003. In addition, the nearly 70,000 Determination applications received by the EP function in FY 2004 far exceeded the planned volume of 42,000. As a result, the EP function continued using revenue agent resources to reduce the backlog of Determination applications and issue Determination letters during FY 2005.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

**Figure 2: Total Determination Letters Issued (FYs 2000 – 2005)**



*Source: Statistics of Income office Table 20 for FYs 2000 – 2005.*

To eliminate the repeated peaks and valleys associated with Determination application receipts since adoption of the Employee Retirement Income Security Act of 1974,<sup>7</sup> the IRS recently published guidance on restructuring the Determinations program. The proposed changes included a process for staggering the due dates of Determination applications for future RAPs. The IRS issued these changes in final form in Revenue Procedure 2005-66, dated September 12, 2005.<sup>8</sup> These changes should help to prevent the RAP peak experienced in FYs 2002 and 2003.

Figure 3 shows that from FYs 2001 – 2003 there was a decrease of 61 FTEs expended on EP function direct Examination operations, while the EP function's overall FTE usage increased by 123. The downward shift in resources devoted to the Examination program and the increase in FTEs devoted to the entire EP function were associated primarily with the need for staffing to address the increase in Determination applications.

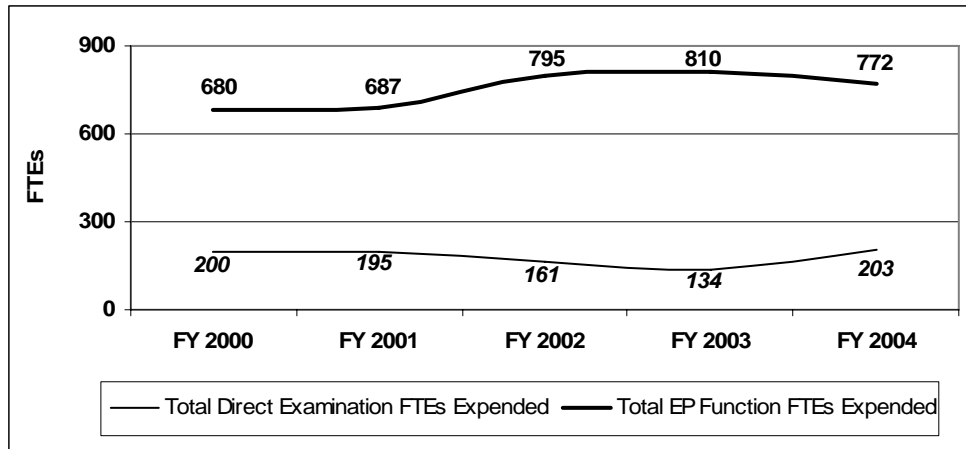
<sup>7</sup> Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.).

<sup>8</sup> Revenue Procedure 2005-66 contains the IRS' procedures for issuing Determination letters pursuant to I.R.C. § 401(a) (2004) with respect to a staggered RAP system for both plans that are and are not preapproved.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

**Figure 3: Total FTEs Expended by the EP Function on Direct Examination Operation Activities and by the EP Function Overall (FYs 2000 – 2004)**



Source: EP function Technical Time Report 11 for FYs 2000 – 2004. Actual FTEs for FY 2005 were not readily available due to issues with implementation of a new management information system. All FTE figures are rounded to the nearest whole number.

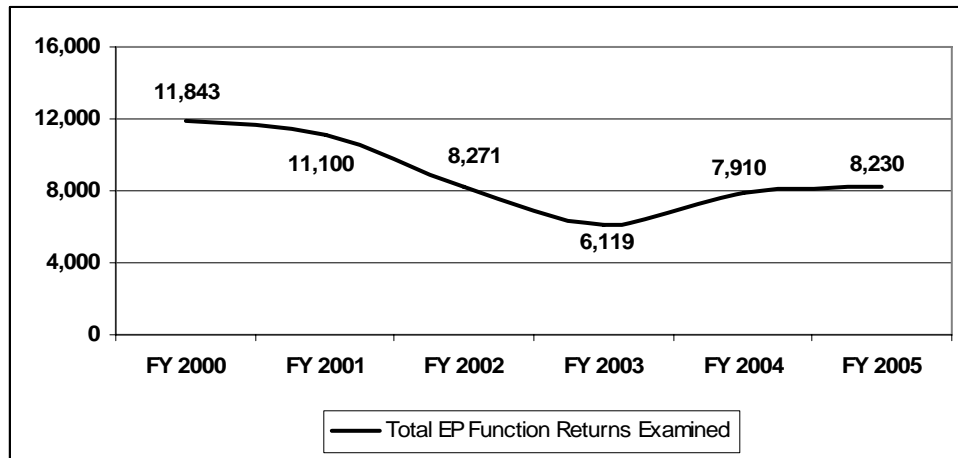
**The number of completed examinations decreased by 31 percent during FYs 2000 – 2005**

There are a variety of measures for gauging the impact of the EP function Examination operation on compliance. One primary measure is the number of examinations completed during a fiscal year. As shown in Figure 4, the total examinations completed significantly decreased during FYs 2000 – 2003, increased over the next 2 fiscal years, but remained 31 percent below the FY 2000 level by the end of FY 2005.



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

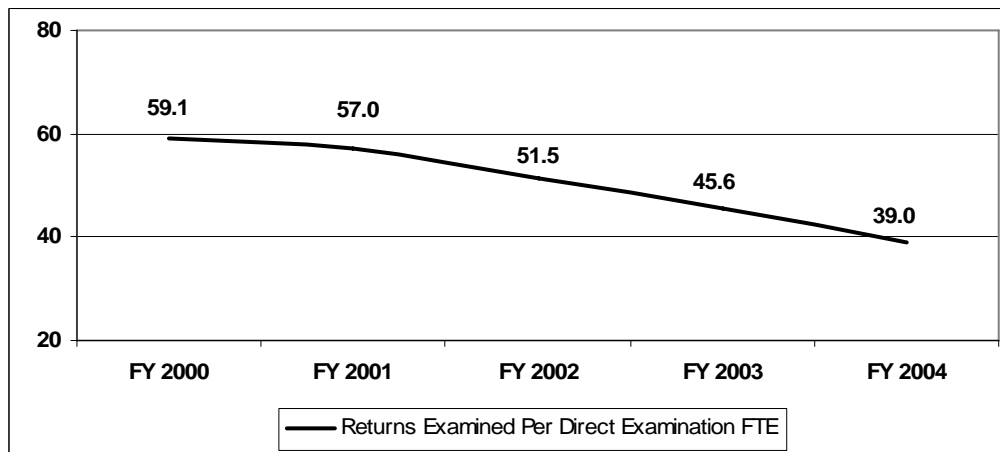
**Figure 4: Total Number of Closed Examinations (FYs 2000 – 2005)**



Source: Audit Information Management System (AIMS)<sup>9</sup> Report 20 (FYs 2000 – 2005).

Figure 5 shows that each year from FY 2000 through 2005, fewer examinations were completed per FTE assigned to the Direct Examination program.

**Figure 5: Closed Examinations per Direct Examination FTE (FYs 2000 – 2004)**



Source: EP function Technical Time Report 11 and AIMS Report 20 for FYs 2000 – 2004. Actual FTE data for FY 2005 were not readily available due to issues with implementation of a new management information system.

The number of examinations completed in a fiscal year is affected by many factors, including complexity of the cases, experience levels of the staff, and the time required to work cases. In addition, during FYs 2000 – 2005 the EP function Examination operation used a variety of

<sup>9</sup> The AIMS provides an automated inventory and activity control for active examination cases.



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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

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approaches for selecting returns for examination and determining the programs that would take priority. Changes in approaches could have affected the length of examinations and the number of examinations completed.

One of the biggest changes occurred in FY 2002, when the EP function Examination operation began a market-segment Risk Assessment program. This program categorized qualified pension plans into 20 market segments and 11 different plan types within each segment, for a total of 220 distinct market segments. EP function Examination operation management gathered a significant amount of information on the risk and reliability of the different segments. The Risk Assessment program's assumptions and sample sizes were reevaluated in FY 2004, and the number of market segments was reduced to 79. In FY 2005, the EP function Examination operation analyzed 20 market segments and had made plans to assign over 5,000 returns for examination.

With the above changes came a shift in the areas the EP function Examination operation emphasized for coverage. Examination results for the EP function Examination operation show this shift beginning in FY 2002 and becoming more prominent in FYs 2003 – 2005. To more clearly compare trends in examination coverage, Figures 6 and 7 and their accompanying Tables (as well as Figures related to time per case, no change rate, and additional assessments) show activity for FYs 2000 – 2002 separate from the activity for FYs 2003 – 2005. Figures 6 and 7 show data from closed examinations for EP function projects, which accounted for the majority of closures.

In general, during the period of this review, the total number of closed examination cases and average closures per FTE were affected by:

- Moving staff to other EP function program priorities (such as the processing of Determination applications) and an associated loss of efficiency when moving staff between different types of work.
- Hiring and training new staff.<sup>10</sup>
- Shifting the types of cases assigned to revenue agents.

As shown in Figure 6, the majority of closures during FYs 2000 – 2002 were related to the Local Classified Issues and Sample Result/Converted Non-Exam categories, with the former category accounting for nearly one-half of all closures in FY 2002. These types of cases are described below.

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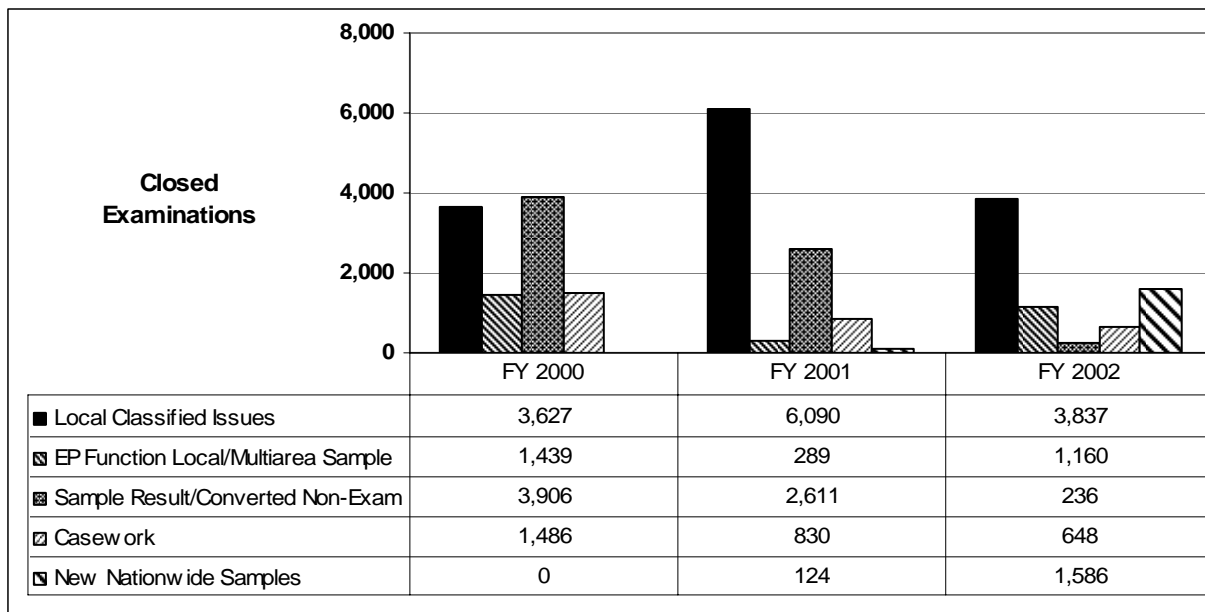
<sup>10</sup> During FY 2005, the EP function Examination operation hired 50 new revenue agents. Because many of these employees were either new to the IRS or had no prior EP function experience, they needed extensive training and generally worked easier examination cases.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

- **Local Classified Issues:** Examinations based on using the Returns Inventory and Classification System (RICS)<sup>11</sup> to identify potential noncompliance when the population may be too small to warrant a research sample.
- **Sample Result:** Examinations based on sample-tested RICS condition codes. Any tested EP function RICS condition codes may be used to select returns as necessary to meet resource needs.
- **Converted Non-Exam:** Examinations based on a decision to convert a case to an examination based on nonexamination activities (e.g., either review of a response or a lack of response to a compliance check letter sent to a taxpayer).<sup>12</sup>

**Figure 6: Closed Examinations for  
Major Areas of EP Function Emphasis (FYs 2000 – 2002)**



Source: AIMS Report 20 for FYs 2000 – 2002.

<sup>11</sup> The RICS provides users with access to return and filer information related to the filing and processing of employee plans, exempt organizations, and government entities forms. It receives data from the Business Master File (the IRS database that consists of Federal tax-related transactions and accounts for businesses; these include employment taxes, income taxes on businesses, and excise taxes).

<sup>12</sup> A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity to determine whether the entity is adhering to record keeping and information reporting requirements. A compliance check is not an examination, and the customer may legally choose not to participate in the compliance check.





## Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005

The Figure 6 Table shows the percentage of total examination closures for each of the above types of examination cases during FYs 2000 – 2002.

**Figure 6 Table**

<b>Area of Emphasis</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>
Local Classified Issues	30.6%	54.9%	46.4%
EP Function Local/Multiarea Sample	12.2%	2.6%	14.0%
Sample Result/Converted Non-Exam	33.0%	23.5%	2.9%
Casework	12.5%	7.5%	7.8%
New Nationwide Samples <sup>13</sup>	N/A	1.1%	19.2%

Source: AIMS Report 20 for FYs 2000 – 2002. The notation “N/A” denotes Not Applicable.

A prior Treasury Inspector General for Tax Administration report<sup>14</sup> on the Examination operation workplan process showed that, while Local Classified Issues helped the EP function meet certain performance goals such as total closures, it was not designed to focus on areas representing the greatest risk of noncompliance. In response, EP function management:

- Established the Risk Assessment program to ensure returns selected for examination have a high probability of noncompliance.
- Continually updated risk assessment data and changed examination focus when warranted, based on examination results, to ensure returns selected for examination further the EP function’s mission of identifying and correcting noncompliance.
- Clarified workplan guidelines for using the number of plan participants when selecting returns for examination. EP function management also cited a need to maintain an appropriate balance on the types and sizes of plans while considering both the number of available revenue agents and their experience.

Figure 7 shows that, during FYs 2003 – 2005, the majority of the EP function Examination operation workload involved Risk Assessment program cases, which accounted for over 80 percent of all EP function Examination operation closures in FYs 2004 – 2005. Following are the 3 areas of examination emphasis that accounted for all closures during these 3 fiscal years:

- Risk Assessment: An initiative that focuses on identifying compliance risks for various industries and plan types, based on data from prior examinations.
- Special Emphasis: Cases selected for examination based on areas of program emphasis included in EP function annual plans. The specific types of issues included in this

<sup>13</sup> Cases selected using a market-segment compliance approach.

<sup>14</sup> *Additional Improvements Will Better Focus the Employee Plans Function’s Examinations Workplan on Areas That Identify and Correct Noncompliance* (Reference Number 2002-10-143, dated August 2002).

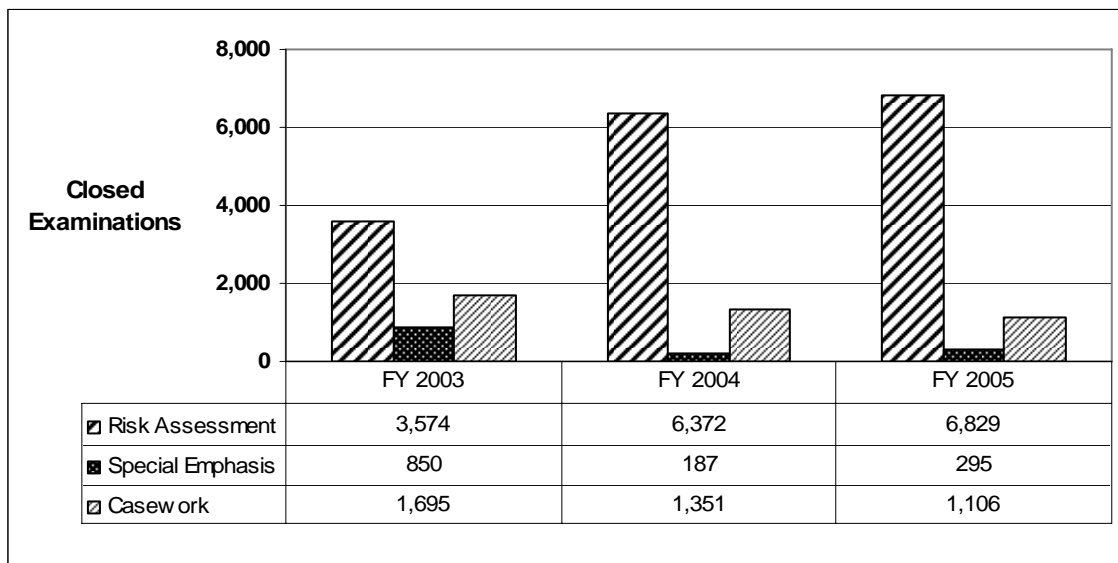


*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

category vary from year to year. In general, these projects are run and monitored by project analysts on the Examination Planning and Program office staff.

- Casework: Examinations originating from sources outside of EP function classification (e.g., referrals from the Department of Labor, tax practitioners, or IRS Examination functions outside of the EP function). In general, since FY 2004 this category has included all cases that do not fall into one of three major Examination programs: (1) Abusive Tax Avoidance Transactions, (2) Risk Assessment, or (3) Employee Plans Team Audit (EPTA) and Exempt Organizations Total Examination Program (EO TEP)/Large and Mid-Size Business (LMSB) Support. The Training and General Case categories also became part of the Other Casework category in FY 2003.

**Figure 7: Total Number of Closed Examinations by Major Areas of EP Function Emphasis (FYs 2003 – 2005)**



Source: AIMS Report 20 for FYs 2003 – 2005.

The Figure 7 Table shows the percentage of total examination closures for each of the above types of examination cases for FYs 2003 – 2005.



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

**Figure 7 Table**

<b>Area of Emphasis</b>	<b>FY 2003</b>	<b>FY 2004</b>	<b>FY 2005</b>
Risk Assessment	58.4%	80.6%	83.0%
Special Emphasis	13.9%	2.4%	3.6%
Casework	27.7%	17.1%	13.4%

*Source: AIMS Report 20 for FYs 2003 – 2005. The totals for some fiscal years may not equal 100 percent due to rounding.*

**The amount of time needed to complete an examination has been increasing**

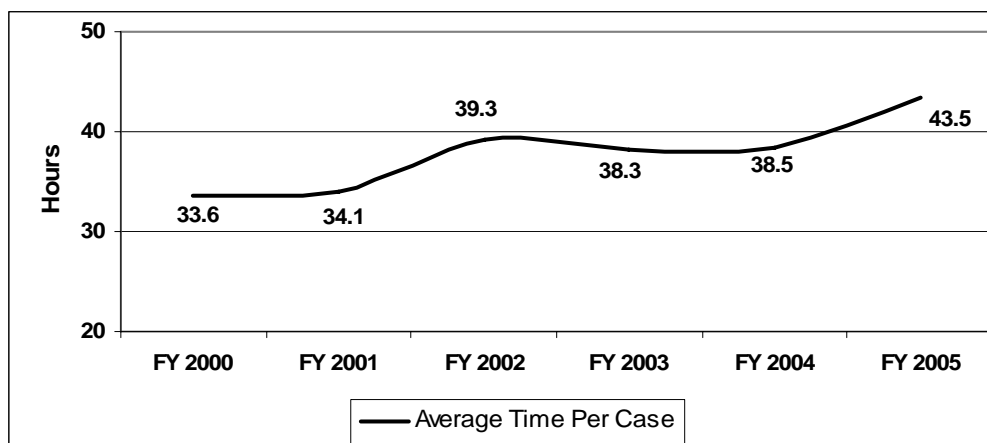
There are two measures for gauging time on examinations:

- Average time per case, which represents the average amount of time revenue agents devoted to completing examination cases.
- Cycle time, which is measured from the date a taxpayer is contacted to the date the examination case is closed on the AIMS.

As shown in Figure 8, the average time per case increased nearly 30 percent (from 33.6 hours to 43.5 hours per case) in the 6-year period ending in FY 2005. The most noticeable increases occurred in FYs 2002 and 2005. Reviews by EP function staff indicated these increases were generally related to EP function revenue agents:

- Working a split inventory of Examination program and Determinations program cases.
- Conducting audits of returns with more complex issues.

**Figure 8: Average Time per Case (FYs 2000 – 2005)**



*Source: AIMS Report 20 for FYs 2000 – 2005.*

A task group of EP and Exempt Organizations function managers and revenue agents met in 2003 to review the examination process and make recommendations that would result in



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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

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selecting better cases and reducing both cycle time and customer burden. One recommendation was to expand the use of “focused” or “limited-scope” examinations. Under this approach, agents assess internal controls, use more effective interview techniques, and examine several specific issues. This allows agents to limit audit activity with compliant customers and do more comprehensive examinations of potentially noncompliant customers.

The EP function Examination operation conducted a pilot to test this concept in March 2004 and completed the test in March 2005. The 625 cases closed using this approach showed a 23 percent decrease in time per case and a 27 percent reduction in cycle time.

Other factors affecting the timeliness of EP function examinations from FYs 2002 – 2005 included the following:

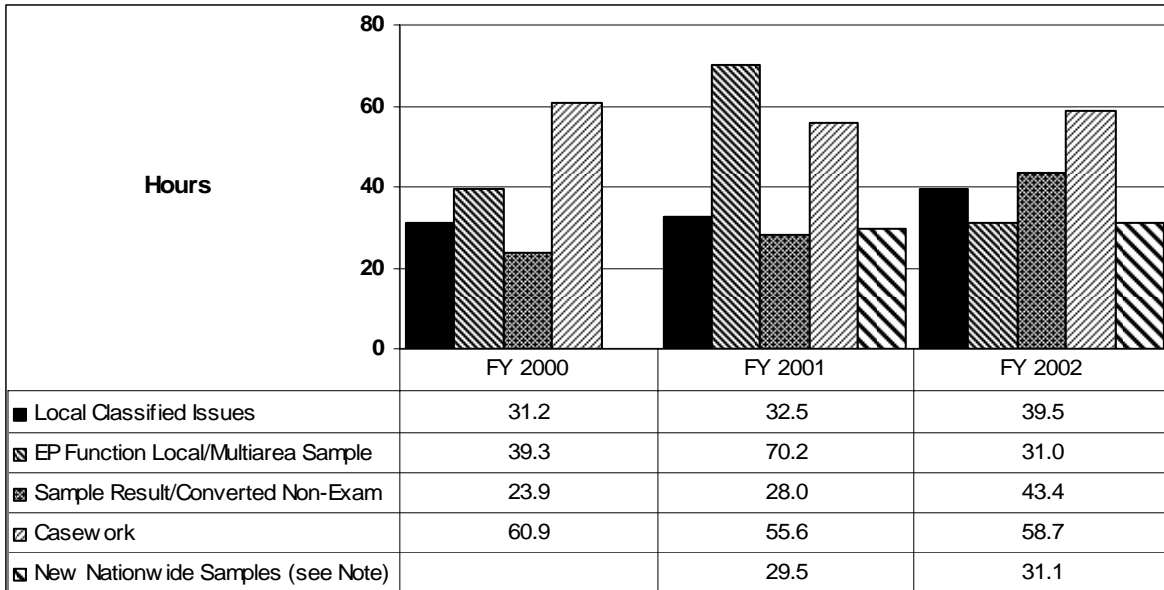
- FY 2002: A shift in emphasis to more complex and time-consuming examinations of larger plans (i.e., those with more participants) resulted in an increase in the average time per case.
- FY 2003: An EP function operational review in May 2003 noted the slight improvement in time per case was due to a much larger percentage of Risk Assessment program returns, which revenue agents closed in an average of 29 hours per case. These accounted for nearly one-half of all closures in FY 2003 versus only 12.5 percent in FY 2002. There was also significant improvement in time per case within the Other Casework category of examinations, which includes several types of cases such as third-party referrals and reported funding deficiencies.
- FY 2005: The overall rise in time per case primarily resulted from less experienced staff conducting more examinations of market-segment cases.

Figures 9 and 10 show average time per case for key programs, which represent the majority of total closures for each fiscal year shown (see Tables included with Figures 6 and 7).



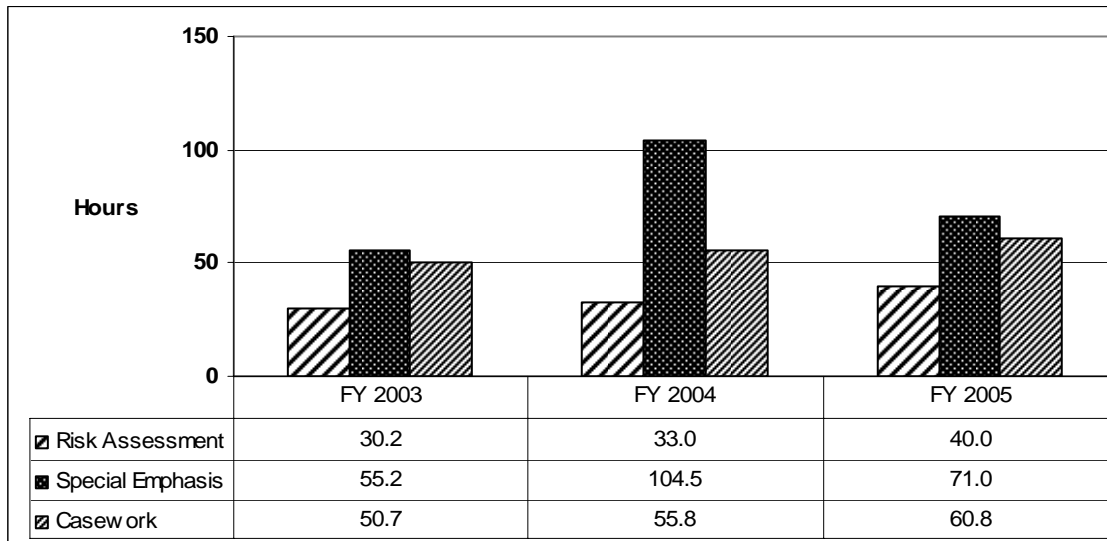
*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

**Figure 9: Average Time per Case, Key Program Areas (FYs 2000 – 2002)**



Source: AIMS Report 20 for FYs 2000 – 2002. Note: There were no cases for “New Nationwide Samples” in FY 2000.

**Figure 10: Average Time per Case, Key Program Areas (FYs 2003 – 2005)**



Source: AIMS Report 20 for FYs 2003 – 2005.

There was wide variation in EP function examination cycle times during the past 6 fiscal years, as illustrated in Figure 11. This trend is attributable to many of the same issues as those associated with time per case. In addition, EP function reviews completed during

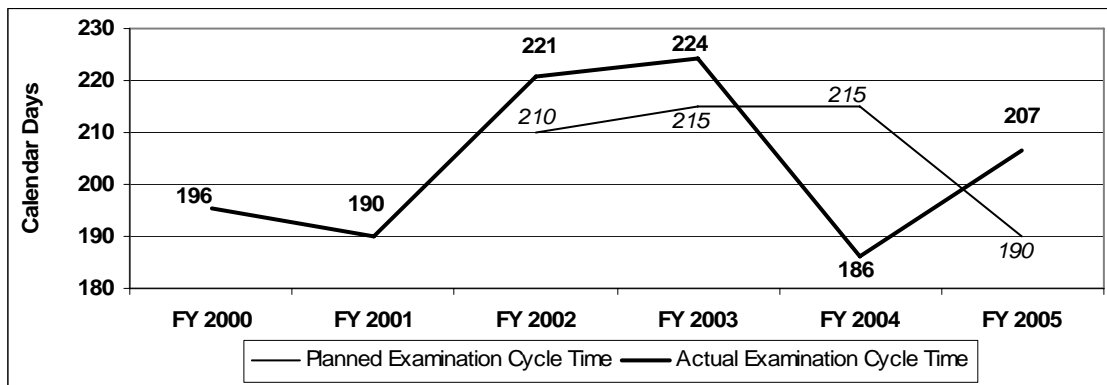


## Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005

FYs 2002 – 2005 addressed cycle time and cited specific steps EP function management has taken to improve timeliness:

- FYs 2002 – 2003: EP function management expected cycle time to increase due to shifting Examination operation resources to the Determinations program, revenue agents working “split” inventories of Examination program and Determinations program cases, a significant need for higher graded agents to work Determination applications, less experienced agents conducting examinations, and a 16 percent increase in cycle time during FY 2003 for Closing Agreement Program cases.<sup>15</sup>
- FY 2004: Average cycle time decreased 38 calendar days during the fiscal year as EP function Examination operation revenue agents were no longer working split inventories. At the end of FY 2003, the EP function Examination operation permanently reassigned 95 employees to dedicated Determinations program groups so revenue agents would no longer have to be reassigned to the Determinations program during the year.
- FY 2005: The EP function Examination operation increased the original 190 calendar day cycle time projection to 200 calendar days in August 2005 after analyzing data for the first 9 months of FY 2005. In addition, the EP function Examination operation asked Area Offices<sup>16</sup> to target the “top 10” oldest cases (an action cited as one reason for increased cycle time). There was also a 20 percent increase in average time per case for market-segment examinations due to an increase in the number of cases closed with changes.

**Figure 11: Cycle Time (FYs 2000 – 2005)**



Sources: AIMS Report 61 and EP function annual workplans for FYs 2000 – 2005.

<sup>15</sup> Revenue Procedure 2002-47 (July 22, 2002) contains provisions for updating the comprehensive system of correction programs for sponsors of retirement plans that are intended to satisfy the requirements of I.R.C. §§ 401(a), 403(a), 403(b), or 408(k) but that have not met these requirements for a period of time.

<sup>16</sup> The EP function Examination operation has five Area Offices that report to the EP function National Office and provide guidance to local EP function offices.



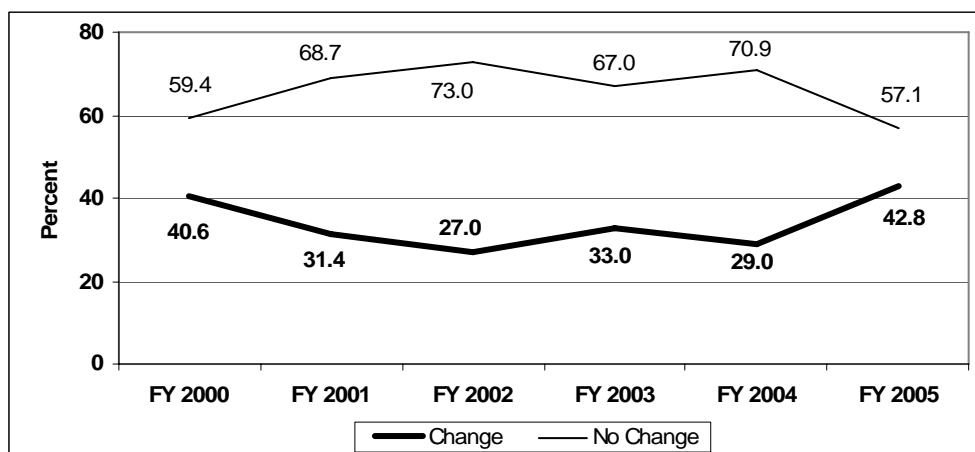
## Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005

### The change rate significantly improved after several years of an overall decrease

Another indicator of Examination program impact is the percentage of cases resulting in some type of change due to noncompliance with the I.R.C. Overall, the rate of change fell during the early period of our review period but in FY 2005 reached its highest level since FY 2000.

Figure 12 shows the percentage of examinations resulting in either a change or no change over the past 6 fiscal years.

**Figure 12: Change Rate (FYs 2000 – 2005)**



Source: AIMS Report 20 for FYs 2000 – 2005. The total rate of change for some fiscal years may not equal 100 percent due to rounding.

While the number of completed examinations increased in each of FYs 2003 – 2005, there was still a significant number of closures for returns deemed to be compliant (i.e., no-change closures). The EP function workplan for FY 2006 includes two specific actions to better focus compliance activities so revenue agents can more effectively and efficiently perform audits:

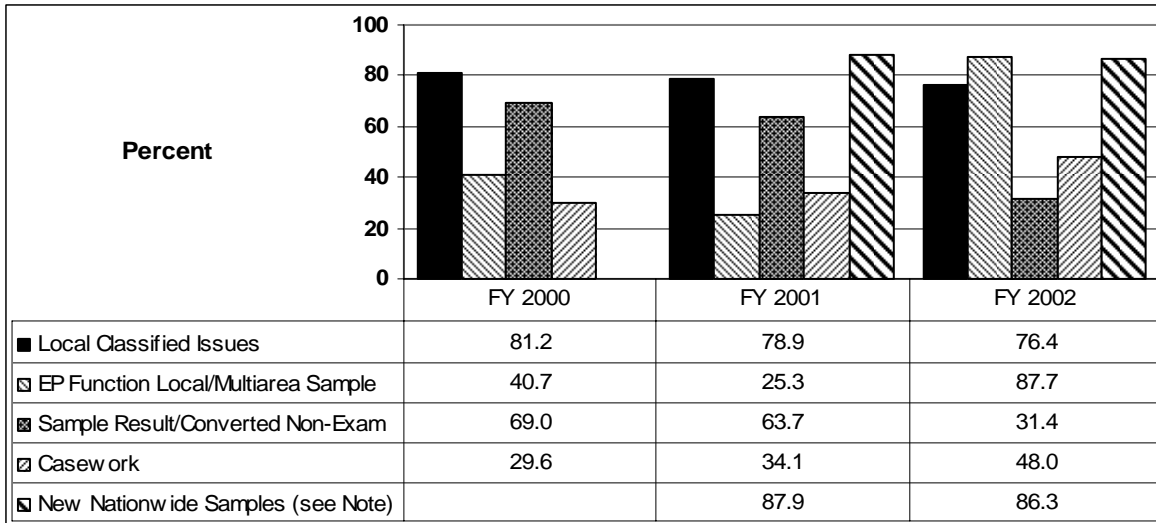
- Assign examinations needed to complete the baseline Risk Assessment program.
- Expand the focused examination concept to all examinations so agents have a process for identifying and targeting key issues based on plan type and industry.

Figures 13 and 14 provide the no-change rate for major Examination programs during FYs 2000 – 2002 and FYs 2003 – 2005.



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

**Figure 13: No Change Rate, Key Program Areas (FYs 2000 – 2002)**



Source: AIMS Report 20 for FYs 2000 – 2002. Note: There were no cases for “New Nationwide Samples” in FY 2000.

The above categories accounted for over 75 percent of all closures for FYs 2000 – 2002. While the no-change rate was relatively constant for the Local Classified Issues and New EP Function Nationwide Sample categories during this period, there were generally wide fluctuations in other categories.

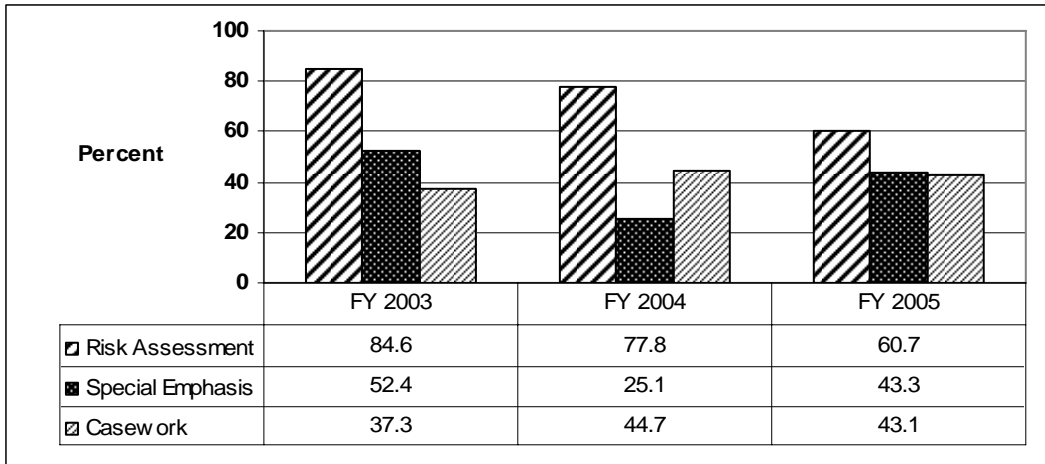
Since the EP function adopted its market-segment approach in FY 2003, there has been an overall decrease in the no-change rate for returns EP function revenue agents examined to validate the Risk Assessment program process. For example, in the 3-year period ending in FY 2005, there was a significant drop in the no-change rate for the Risk Assessment category, from 84.6 percent to 60.7 percent. During the same period, the number of returns examined for this category increased 91 percent and accounted for over 80 percent of all closed examinations in FYs 2004 and 2005.





*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

**Figure 14: No Change Rate, Key Program Areas (FYs 2003 – 2005)**

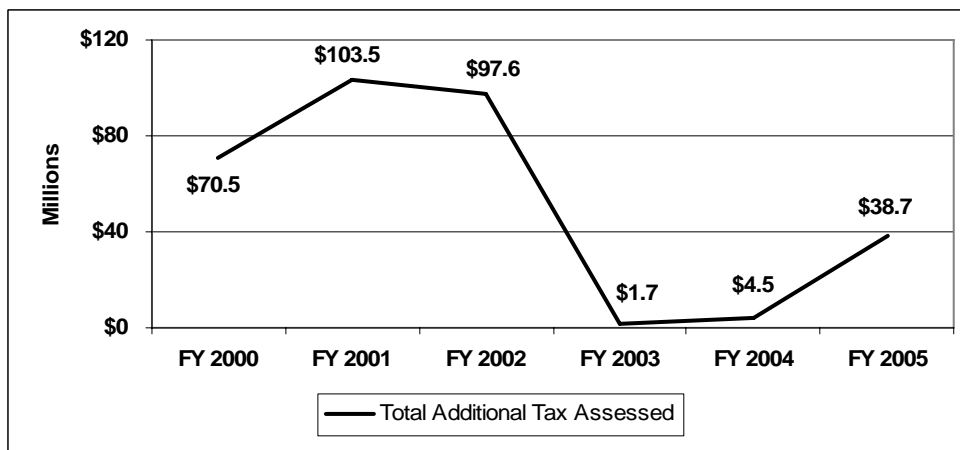


Source: AIMS Report 20 for FYs 2003 – 2005.

**Assessment amounts for noncompliant plans have decreased from the early periods of our review**

Another indicator of the success of the Examination program is the amount assessed for the noncompliance issues identified during examinations. Figures 15 through 18 show the total amounts assessed during FYs 2000 – 2005 as well as total assessments for key EP function Examination programs.

**Figure 15: Total Additional Tax Assessed (FYs 2000 – 2005)**



Source: AIMS Report 20 for FYs 2000 – 2005.

The EP function’s annual workplans include priorities to support the IRS Strategic Plan goal of Enhancing Enforcement of the Tax Law. In recent years, there have been numerous news



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

articles about the dramatic increase in defunct pension plans taken over by the Pension Benefit Guaranty Corporation. Over the past few fiscal years, the EP function’s areas of examination emphasis have shifted to address these concerns and include the following strategies:

- Monitoring pension funding.
- Detecting and deterring abusive tax schemes.
- Refining compliance risk assessments with data from examinations.

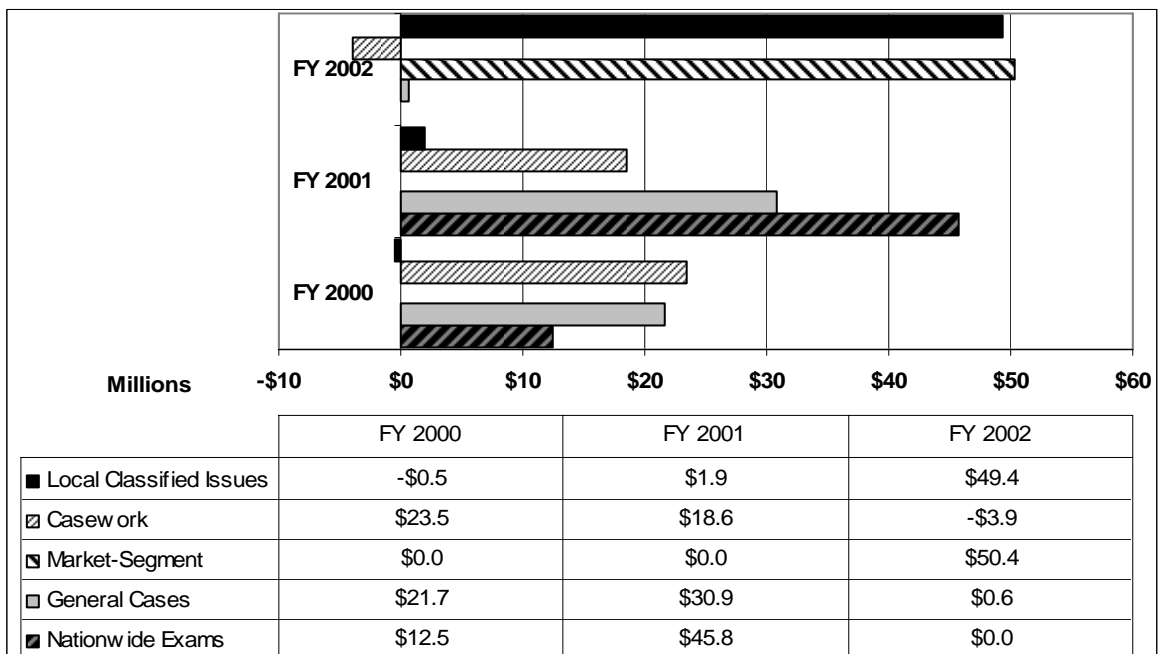
Through the end of FY 2005, there were relatively few completed examinations in the area of abusive tax avoidance transactions. However, on average, these cases resulted in a sizeable amount of additional tax assessments.

Figures 16 through 18 (and their accompanying Tables) provide a more detailed breakdown of total tax assessments by the EP function Examination operation, including:

- Total dollars assessed for selected programs/projects.
- Percentage of total assessments that each of these areas comprise.

These programs were chosen because they represent the majority of total assessments made during each fiscal year covered in our review (see Figures 16 and 17).

**Figure 16: Examination Assessments, Key Program Areas (FYs 2000 – 2002)**



Source: AIMS Report 20 for FYs 2000 – 2002. General Cases include examinations that were worked on an as-needed basis to balance staff assignments.



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

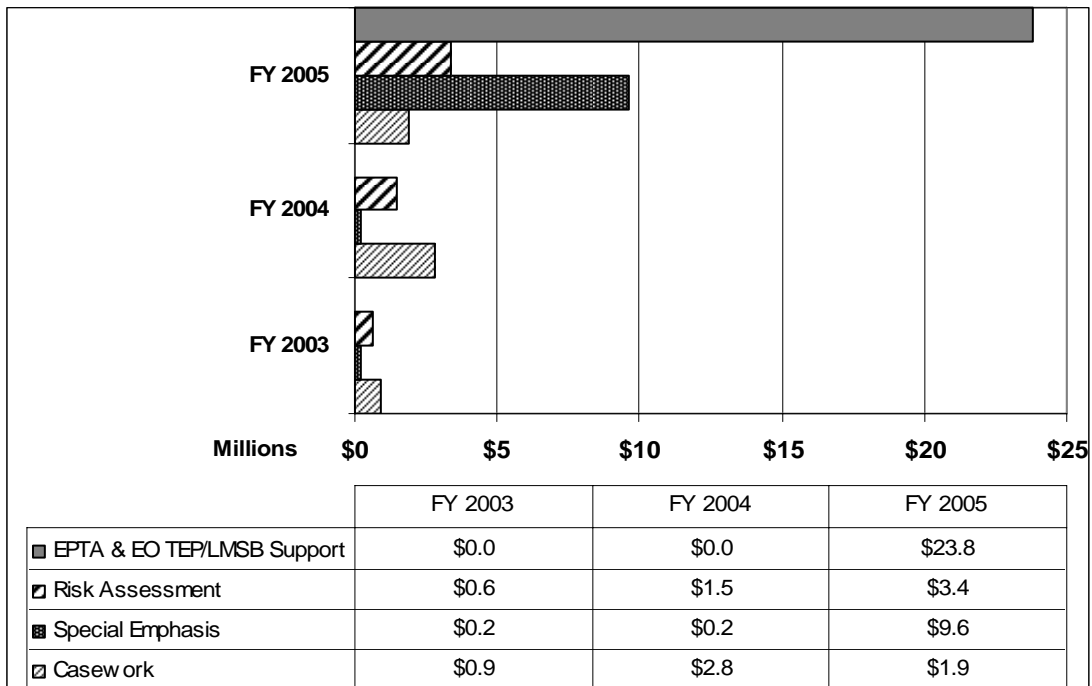
The Figure 16 Table shows the percentage of total additional assessments that the key program areas accounted for during this period.

**Figure 16 Table**

<b>Area of Emphasis</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>
Market-Segment	N/A	N/A	51.7%
General Cases	30.8%	29.9%	0.6%
Local Classified Issues	-0.7%	1.8%	50.6%
Casework	33.3%	18.0%	-4.0%
Nationwide Exams	17.7%	44.2%	N/A

Source: AIMS Report 20 for FYs 2000 – 2002. The notation “N/A” denotes Not Applicable.

**Figure 17: Examination Assessments, Key Program Areas (FYs 2003 – 2005)**



Source: AIMS Report 20 for FYs 2003 – 2005. The category “EPTA & EO TEP/LMSB Support” (Employee Plans Team Audit & Exempt Organizations Total Examination Program/Large Mid-Sized Business Support) includes assessments associated with examinations of the largest plan sponsors, including those employers whose corporate returns are under the jurisdiction of the IRS’ Exempt Organizations and Large and Mid-Size Business organizations.

The Figure 17 Table shows the percentage of total additional assessments that the key program areas accounted for during this period.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

**Figure 17 Table**

<b>Area of Emphasis</b>	<b>FY 2003</b>	<b>FY 2004</b>	<b>FY 2005</b>
EPTA & EO TEP/LMSB Support	N/A	N/A	61.5%
Risk Assessment	35.3%	33.3%	8.8%
Special Emphasis	11.8%	4.4%	24.8%
Casework	52.9%	62.2%	4.9%

*Source: AIMS Report 20 for FYs 2003 – 2005. The notation “N/A” denotes Not Applicable.*

The overall downward trend in additional tax assessments during FYs 2002 and 2003 correlates with a decrease in total direct Examination program staffing and closures. However, over the past 2 fiscal years, there has been a significant increase in total assessments.

It is important to note that assessments alone are not a reliable indicator of the effectiveness of a particular Examination program. There are often wide variances in the amount of examination assessments for the various pension plans (due to the size and complexity of the plan and the degree of noncompliance). For example, one completed case can result in several million dollars in additional assessments, but this cannot be expected year after year in the Examination program. Therefore, it would not be reasonable to expect this result the following year or to devote more resources to this type of plan in anticipation of further increases in additional tax assessments.

**Figure 18: Closed Examinations by Projects Having the Highest Average Additional Tax Assessments (FYs 2000 – 2005)**

<b>Project Code/Title</b>	<b>FY 2000</b>	<b>FY 2001</b>	<b>FY 2002</b>	<b>FY 2003</b>	<b>FY 2004</b>	<b>FY 2005</b>
	<i>Average Additional Assessment</i>					
301 Local Classified Issues	\$129	\$306	\$12,871	\$702	N/A	N/A
445 EP Function Risk Assessment	N/A	N/A	N/A	\$21	\$254	\$555
069 Reported Funding Deficiency	\$16,918	\$118,894	\$205,037	(\$5,198)	\$17,598	\$215
068 Referrals	\$16,888	\$27,155	\$5,524	\$863	\$4,836	\$5,245
000 General Cases	\$47,303	\$109,542	\$6,366	\$1,831	\$1,325	\$3,191
078 Coordinated Examination Program Support To Large and Mid-Size Business	\$17,535	\$11,068	\$13,369	\$1,037	\$3,536	\$679,741

*Source: AIMS Report 20 for FYs 2000 – 2005. The notation “N/A” denotes Not Applicable.*

**The Employee Plans function reported improvement in the quality of examinations from the early periods of our review**

Overall, the quality of examinations conducted by the EP function Examination operation improved and ranged from 84 percent to 86 percent over the past 3 fiscal years. The EP function Quality Review Staff issued quarterly reports with comprehensive narratives detailing where revenue agents did well and where there was a need for improvement.



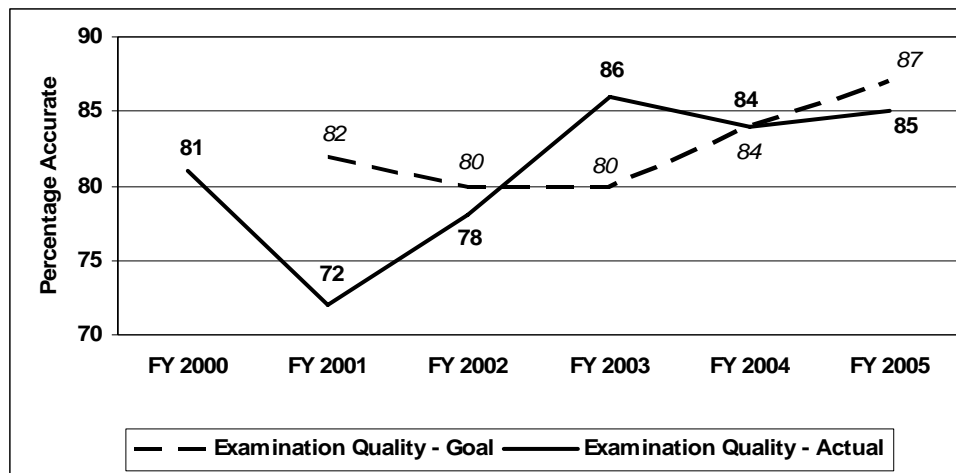
## Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005

The Total Examination Quality Measurement System (TEQMS) is designed to measure the quality of cases. The TEQMS provides EP function management with data to assess organizational performance and identify improvement opportunities. For EP function Examination operation cases, the System is designed to measure the quality of the EP function Examination operation case process and provide statistical and narrative commentary at the Area Office and National levels. The System includes eight quality standards, each having specific elements, aspects, and reasons that measure case quality. The standards provide objective criteria against which case quality is evaluated.

Starting in FY 2001, the EP function Examination operation established specific goals for examination quality. The initial goal of an 82 percent accuracy rate has increased over the past 2 fiscal years and was set at 87 percent for FY 2005. During FYs 2000 – 2002, the TEQMS showed the quality rate ranged from a high of 81 percent to a low of 72 percent. During the latter part of our review period (FYs 2003 – 2005), quality improved and was consistently near 85 percent.

Figures 19 and 20 show overall TEQMS results for FYs 2000 – 2005 as well as the three standards having the lowest overall ratings.

**Figure 19: Examination Quality (FYs 2000 – 2005)**

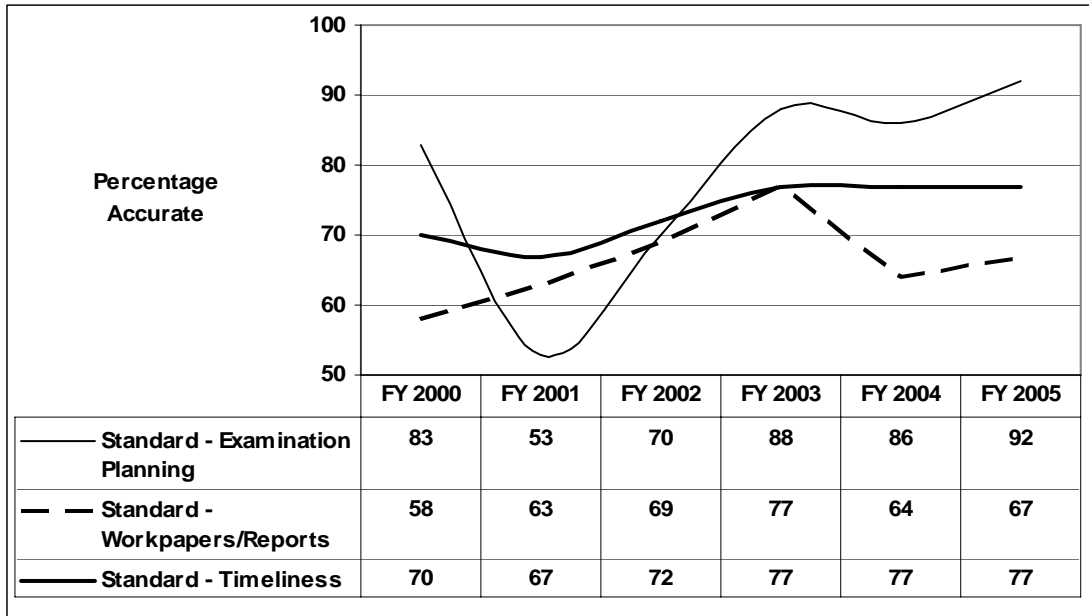


Source: TEQMS Reports (FYs 2000 – 2005).



*Trends in Employee Plans Function Enforcement Activities for Fiscal Years 2000 – 2005*

**Figure 20: Examination Quality (FYs 2000 – 2005)**



Source: TEQMS Reports (FYs 2000 – 2005).

Below are definitions for each of these standards:

- Examination Planning: Measures whether the pre-audit identified material issues; initial requests for information were clear, concise, appropriate, and addressed the potential issues selected; and necessary steps were taken to set the groundwork for a complete examination.
- Workpapers/Reports: Measures documentation of the examination’s audit trail, techniques used, procedures applied, and examiner’s activity on the case. This standard also measures whether there is sufficient documentation to support the conclusions reached and the computations are accurate.
- Timeliness: Measures use of time and timeliness of actions throughout the examination process.

**Customer Satisfaction ratings were generally consistent and met established goals during the period of our review**

Customer Satisfaction ratings for examinations were generally consistent and met the EP function Examination operation’s goals for FYs 2002 – 2005. Over the past 3 fiscal years, the EP function workplan for the Examination operation has included a section on Customer Satisfaction with comments about previous and planned actions the EP function Examination operation was taking to maintain or improve high ratings for this performance indicator.



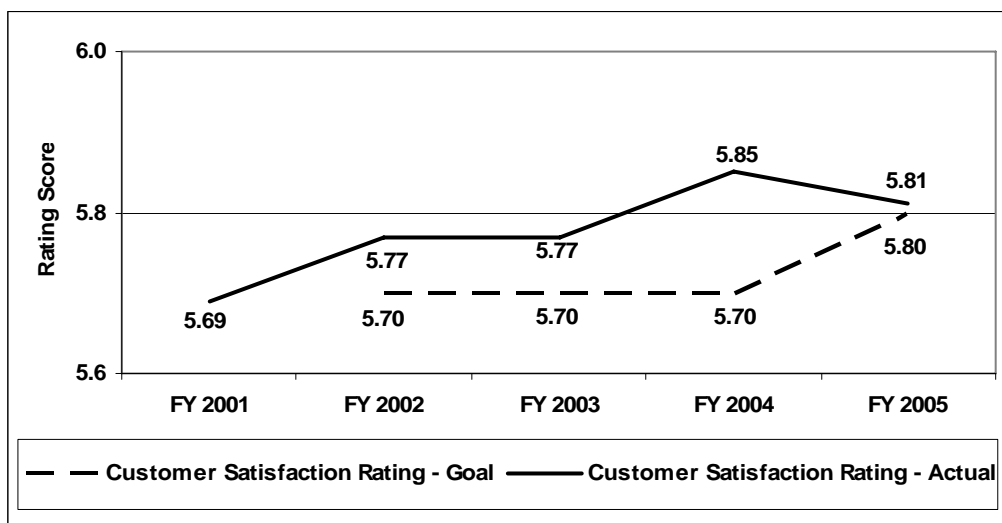
*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

For example, the workplan shows each of the Area Offices initiated projects to improve customer satisfaction, particularly in areas of “time spent on audit” and “explanation of process.” Customers rated these 2 items as having the highest priority for “improvement opportunities” in each of the past 3 fiscal years. Actions taken to address these areas include:

- Development of a special publication, *Understanding the Employee Plans Examination Process* (Publication 1-EP), which includes an explanation of the audit process to EP function customers.
- An initial appointment letter to explain why the taxpayer was selected for audit.
- A web-based examination guide for use by external customers.
- Training classes for revenue agents.
- Partnerships with practitioners.

During FYs 2001 – 2005, the overall Customer Satisfaction rating ranged from 5.69 to 5.85 on a 7-point scale (where ratings of 6 or 7 were designated as satisfied customers and ratings of 1, 2, or 3 were designated as dissatisfied customers). Starting in FY 2002, the EP function Examination operation established a specific goal of achieving an overall 5.70 Customer Satisfaction rating and in FY 2005 increased this to 5.80. In FY 2003, the EP function Examination operation added a second goal of having 70 percent of all customer ratings be in the “satisfied” range (rating of 6 or 7); the EP function increased this to 72 percent in FY 2005. Figures 21 and 22 show Customer Satisfaction ratings for both of these measures.

**Figure 21: Overall Examination Customer Satisfaction (FYs 2001 – 2005)**

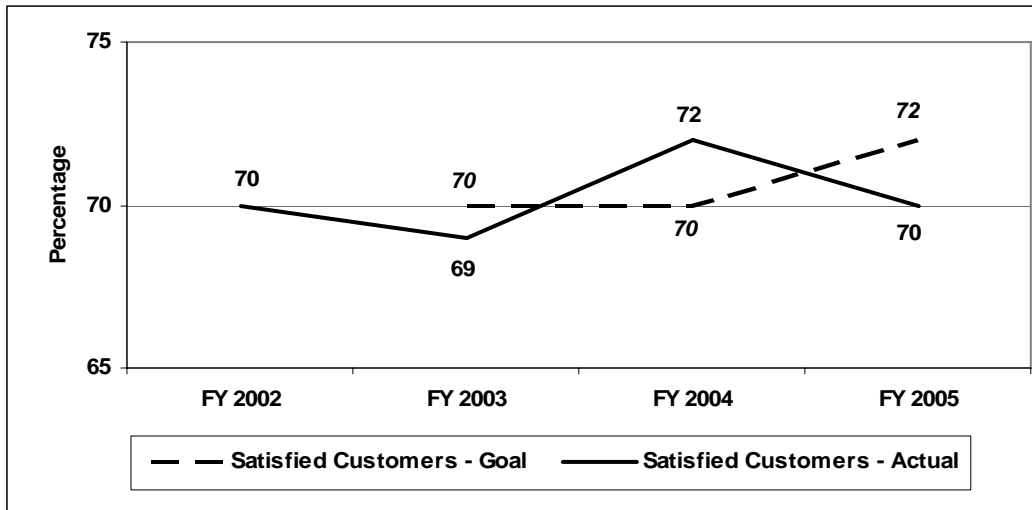


Source: *Customer Satisfaction Surveys (FYs 2001 – 2005)*. These ratings are based on data gathered for the 6-month period ending in March of each fiscal year.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

**Figure 22: Examination Customer Satisfaction –  
Percentage of Satisfied Customers (FYs 2002 – 2005)**



Source: Customer Satisfaction Surveys (FYs 2001 – 2005). These percentages are based on data gathered for the 6-month period ending in March of each fiscal year.





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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 – 2005*

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## **Appendix I**

### *Detailed Objective, Scope, and Methodology*

The overall objective of this audit was to review relevant statistical data concerning the EP function's enforcement activities for FYs 2000 – 2005 and analyze the data for trends. To accomplish this objective, we reviewed Internal Revenue Service data publications and EP function Examination operation information. We relied on information accumulated by the IRS and EP function in established reports and did not verify its accuracy. Specifically, we:

- I. Identified areas of emphasis for the EP function's enforcement activities for FYs 2000 – 2005 and determined how resources were allocated.
  - A. Obtained EP function workplans and program guidance to identify the major strategies, operating priorities, goals, and objectives.
  - B. Interviewed EP function management to identify the factors used in determining the key program areas (e.g., expected high rate of noncompliance).
- II. Determined the factors EP function management used to gauge the overall success of key enforcement areas.
  - A. Interviewed EP function management to determine the criteria used in determining the success of individual examinations and the overall Examination program.
  - B. Determined the data EP function management used to track the measures.
- III. Analyzed data relating to the EP function's enforcement activities for FYs 2000 – 2005.
  - A. Obtained EP function Technical Staffday Analysis reports to identify the total planned staff days for the EP function Examination Program.
  - B. Obtained Tax Exempt and Government Entities Division Technical Time Reporting System<sup>1</sup> data to determine the total time applied to EP function examination operation activities.

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<sup>1</sup> The TE/GE Technical Time Report is used to gather information required by management at all levels for time application by TE/GE personnel in the Area Offices.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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- C. Obtained Statistics of Income office data to determine the total number of returns examined and associated results.
- D. Obtained Audit Information Management System<sup>2</sup> data to identify the total number, source, type of closure, and time expended on examinations of EP function returns.
- E. Determined the extent of the productive and nonproductive trends for EP function-related returns.

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<sup>2</sup> The AIMS provides an automated inventory and activity control for active examination cases.



*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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**Appendix II**

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*Trends in Employee Plans Function Enforcement Activities for  
Fiscal Years 2000 - 2005*

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**Appendix III**

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