Advisory Committee on
Tax Exempt and Government Entities
(ACT)

IV. Audit Cycle Time and Communications: *Employee Plans and Tax Exempt Bonds*

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BACKGROUND

The ACT has previously issued reports relating to the educational and voluntary compliance aspects of TE/GE. In those reports, we identified a third, important element of the role of TE/GE: examinations or audits. Two years ago we undertook a report on TE/GE audit programs to explore methods in which the audit program can be made more effective and as painless as possible to filers. During the course of this exploration, TE/GE itself has undertaken a program related to exam reengineering (now christened the "Filing to Closure Examination Redesign Team"). This report collects ACT's observations concerning specific aspects of the audit process as it relates to Tax-Exempt Bonds and Employee Plans. A parallel report collects observations concerning the audit process as it relates to Exempt Organizations.

Purposes of an Audit

An effective audit program serves several purposes:

1. **Visible enforcement** – Encourage self-compliance by others.
2. **Correction** – Ensure that past improper practices are corrected retroactively.
3. **Compliance** – Ensure that the taxpayer operates in compliance going forward and that current rules can be complied with (demonstrate that the rules work).
4. **Data Gathering for Education** – Collect information to shape audit process and self-corrections processes.
5. **Identification of Abusive Transactions** – Identify and examine potentially abusive transactions in a timely fashion.

Self-compliance is the cornerstone of U.S. tax compliance. An effective audit program can encourage higher compliance by ensuring that non-compliers are targeted for audit and that persons who are abusing the tax process experience heavy penalties relative to those who are merely negligent or who do not profit from their non-compliance. Accordingly, we believe that audit processes should be shaped to target abusive practices and be more tolerant of those who do not profit from their noncompliance.

Auditors should determine whether required tests and activities are undertaken, and test the honesty and integrity of the information being provided to the Service. Missed processes and inaccurate information should be corrected retroactively, and the Service should be prepared to help those audited identify how to correct their processes and information going forward.

An effective audit program should include informational feedback elements to help the Service in its other missions. Results of audits should be used to help identify

issues about which taxpayers need greater education, practices that should be reviewed as part of future audits, and areas where self-corrections processes could be expanded. Audits can also be the means by which the Service gains greater understanding of how an industry operates, as with the Service's 2003 audits of single-family housing bond issues.

Who is the taxpayer?

In income tax cases, the taxpayer and auditee are the same and easily identifiable – the individual or corporation responsible for paying the income tax. In an employee plan, the plan is audited, but the true tax risk lies with the plan sponsor, who has responsibility for administering the plan and needs to take appropriate action to keep the plan qualified, even though plan disqualification triggers tax consequences for plan participants. With tax-exempt bonds, the issuer is the taxpayer responding to the audit, even though bond disqualification triggers tax consequences for the bond holder.

GENERAL OBSERVATIONS

Below are some observations concerning the TE/GE audit process generally, focusing on Audit Cycle Time and Communications with taxpayers. Following our general observations are a discussion of these and other observations as they relate to Employee Plans and Tax-Exempt Bonds.

COMMUNICATIONS WITH THE TAXPAYER

1. **Improved Web-based Tools.** *Establish web-based audit process guides and other web-based tools.*

   We strongly support and urge the use of web-based audit process guides and information, including timeline management, hyperlinks and guides specific to taxpayer rights involving bonds, employee plans and exempt organizations.

2. **Soft Contacts.** *Initiate audits through "Soft Contacts".*

   Often the first a taxpayer hears of an audit is through a letter announcing the audit. We encourage TE/GE to seek alternate means to initiate contact. For example, the EO division has undertaken to send taxpayers with certain types of errors on their returns a brief letter, noting that the return may be inaccurate on a specific issue, and then perform an audit only if the error is not corrected, or perform the audit the following year. Accordingly, we strongly recommend the

use of "soft contact" letters where appropriate, to determine whether a particular compliance problem exists.

3. **Manage Taxpayer Expectations.** *Set expectations early and simply.*

We encourage TE/GE to clearly communicate expectations to taxpayers at the onset of the audit. Taxpayers should receive a brief letter in plain English, outlining the areas being audited (if it is a focused audit), the anticipated timeline, and the demands expected to be placed on the taxpayer. For large cases this might take the form of a much more extensive meeting or series of meetings to agree on an audit schedule. Whether the case is large or small, we encourage TE/GE to contact the taxpayer personally to discuss these expectations.

4. **Cooperative Approaches.** *We encourage TE/GE seek more cooperative approaches, and in particular to adopt a practice of entering into audit contracts of the type implemented by the Service's LMSB division.*

Our vision here is that TE/GE would have an initial meeting with the taxpayer, identify topics to be audited and expected document needs, and then agree with the taxpayer on a schedule for completing the audit. While this might be most effective with large corporations, we urge TE/GE to consider developing similar approaches for medium-sized and even small cases, such as a simple phone call followed up with a brief letter confirming expected time frames for key stages of the audit process.

5. **Advance Notice of Actions**. *We encourage TE/GE to provide ample advance notice of actions, such as IDRs, on-site visits, or actions requiring taxpayer response.*

6. **Closing Processes.** *We recommend TE/GE simplify closing letters and actively communicate general findings.* In particular, we encourage TE/GE to actively communicate findings more quickly and reduce the delay between the final on-site visit or substantive communication and the final closing letter.

7. **Communicating Common Errors.** *We recommend TE/GE prepare and communicate to taxpayers "top ten" lists of common audit problems, and "red flag" facts that suggest possible underlying problems.*

We encourage TE/GE to publicize common errors and risk areas in order to increase compliance. Something like a "Top 10" list of common problems found on audit would be a good way of raising taxpayers' consciousness.

REDUCING CYCLE TIME

"Cycle time" is defined by the IRS as the period between the date of an auditable event (such as filing of an informational return) and the date an audit is completed. From the taxpayer's point of view, the "cycle time" is measured from when the notice of audit is received to when the auditor is out-the-door and the letter of no action or other decision letter is received. Long cycle times generate taxpayer dissatisfaction and impede effective audits as memories become stale or documents become difficult to retrieve.

Below are a number of suggestions for reducing the length of time in a typical audit cycle.

1. **Case Selection.** *Employ techniques that focus examination selection on the most likely problem cases.*

   The initial selection decision is an important step in audit efficiency. Careful case selection can minimize the amount of taxpayer and TE/GE time spent on audits which don't uncover any compliance failures. We support EP's recent efforts to improve, refine and expand the use of the "risk assessment" technique for audit case selection. We encourage EP to continue to refine its risk assessment approach.

2. **Pre-Contact Planning.** *Plan the audit prior to any contact with the taxpayer.*

   Before engaging with the taxpayer, TE/GE should make every effort to prepare for the audit. This could include careful review of information on the return, identifying and reviewing information available from other resources, reviewing the Internal Revenue Manual and relevant legal authority, determining audit scope, and preparing document requests where appropriate. We encourage the TE/GE require agents to prepare accurate and focused data requests, rather than request a laundry list of documents in a kind of shotgun approach.

3. **Focused Audits.** *Develop programs to expand the use of "focused" or "limited scope" audits.*

   We also believe there are potentially greater efficiencies available through the expanded use of "limited scope" or "focused" audits – audits which target a select number of issues. By identifying a limited number of audit issues during the pre-contact planning stage, TE/GE can narrow the initial inquiry, leading to faster document production and faster resolution of those issues.

4. Different audit techniques for different case types. *Continue to apply alternate audit approaches, and in particular to implement joint agreements with taxpayers in large cases.*

Different audit approaches can and should be applied under different conditions. Variables such as the taxpayer's size, history or industry may warrant a different approach. For large cases, TE/GE should implement a program of negotiating audit schedules with the taxpayer, implementing the cooperative approaches discussed above in the context of Communication with the Taxpayer.

5. Agent Selection. *Match cases to agents based on expertise, not geography, and actively manage agent inventory.*

We believe audits will be concluded faster and with greater efficiency for both TE/GE and the taxpayer if the auditor has specific experience with the type of issues under audit. We recognize that matching the agent to the case may not always be possible within a single geography, and encourage TE/GE to carefully consider the opportunities to conclude an audit more efficiently, despite the additional travel costs of bringing in an auditor from another geographic area.

We also encourage TE/GE managers to actively review and manage agent caseload. We also encourage TE/GE to keep inventory at manageable levels, to allow agents to work cases more frequently, reduce cycle time and thereby increase throughput and decrease customer dissatisfaction with long cycle times.

6. Agent Training. *Devote significant resources to training examination agents.*

We encourage TE/GE to devote significant resources to training new examiners, and to work with outside resources to develop training materials. Attorneys and accountants experienced in responding to audits may be among the best resources to help train new auditors.

7. Active Case Management. *Actively manage cases and caseloads by establishing guidelines and norms for the amount of time a case should take, monitor agents' progress frequently, and consider use of on-line tools and administrative staff to monitor time lines.*

We recognize that each case is different and may require different resource and time commitments. However, we believe that there should be enough common elements to set reasonable norms and guidelines for how long a case should take, particularly small cases or cases handled via a correspondence audit. We encourage TE/GE to establish guidelines and norms for the amount of time a case should take, and monitor agents' activities frequently and at a depth

necessary to detect timeline problems well before the case starts exceeding the norms.

8. **Coordination with Self-Correction Procedures.** *To the extent audit cycle time is improved by initiating audits early, self-correction procedures should be modified.*

   We recommend that self-correction procedures be modified to allow certain audit-identified problems to be handled without the higher fees and penalties. Typically, taxpayers may not identify a plan defect until the next annual recordkeeping cycle. If an audit commences before that cycle is complete, the taxpayer will have been denied the opportunity to rectify the problem through self-correction.

OTHER SUGGESTIONS

We have two other suggestions which don't directly affect communications and cycle time, but which we believe deserve mention.

1. **Audit practices should be consistent nationwide**. We believe consistency is an important element of fairness in any examination program. For this reason, we recommend that TE/GE continue to devote resources to publishing "Audit Guidelines" for use by agents and plan sponsors. These guidelines should be kept up-to-date, and ideally will allow taxpayers to conduct self-audits as well has help prepare for audits initiated by TE/GE.

2. **Identify means to review third-party providers.** We believe that on occasion the practices of third parties should be targeted in audit and compliance reviews, and remedies sought against those third parties. This is an aspirational objective, and one that may require legislation or expanding the scope of Circular 230. Many taxpayers rely on vendors to manage significant parts of their programs. For example, in the issuance of tax-exempt bonds, the content experts are the underwriters and the bond lawyers, and not necessarily the bond issuers. A small governmental entity may issue only one bond series in a decade. Similarly, smaller companies rely heavily on third party recordkeepers or recordkeeper-trustees to establish and operate their retirement plans. These smaller, less sophisticated taxpayers have only superficial understanding of the requirements to which they are subject.

We encourage TE/GE to train agents in use of enforcement tools such as Section 6700 (promoter penalties) or Section 6701 (aiding and abetting penalties), referrals to the IRS Office of Professional Responsibility, or referrals to Criminal Investigation (CI). We believe TE/GE should consider using these tools more broadly, looking at systemic errors and patterns of poor compliance, and consider expanding the scope of Circular 230

EMPLOYEE PLANS

The Office of Employee Plans ("EP") within the Tax Exempt/Governmental Entities Division of the IRS ("TE/GE") has responsibility for ensuring that retirement plan sponsors understand and comply with the qualification requirements of the Internal Revenue Code and Regulations. EP does so through three main program areas: Customer Education and Outreach; Rulings and Agreements; and Examinations.

EP Examinations

The EP office of TE/GE has had an active examination program for many years. At the present time, approximately 550 revenue agents are assigned to Examinations. They are divided among six regions within the country. The National Director for EP Examinations is located in Baltimore, Maryland.

Examinations has served the traditional role of auditing employee retirement plans and their sponsors for compliance with the Internal Revenue Code. The goal of the Examinations is the promotion of compliance by identifying areas of noncompliance and developing strategies for correction. Examinations works with the other EP program areas in developing and implementing appropriate compliance and enforcement programs.

Traditionally, Examinations has shared its agent resources with Ruling and Agreements. In particular, at times of high volume of determination letter requests, many revenue agents who would normally be conducting audits of retirement plans are instead assigned to process determination letter applications. TE/GE recently introduced a new determination letter process which will spread the determination letter workload more evenly over a five-year cycle. This will allow a more consistent staffing level within the Examinations group.

Ideally, EP Examinations generally expects to conduct 8,000-12,000 audits per year. In the past, the number of audits conducted in a year has fluctuated greatly. This was principally related to the volume of determination letter applications received because of the need to reassign examination agents. The expectation is that the realignment implemented in Fall 2003 will allow for a more focused audit staff, better and more professional customer service, and an increase in the number of examinations. Revenue agents assigned to examination are expected to be more efficient and better at their jobs because of increased specialty training and continuity of job duties. The fluctuation in the number of audits conducted from year-to-year should be eliminated since resources will no longer be shared with Rulings and Agreements.

Our project group had the opportunity to talk with members of the EP management staff, both inside and outside of the Examinations program. We were

impressed by the clear desire of all to continue to improve the EP examination process. Several of the recommendations we make are intended to support ongoing initiatives already underway.

IMPROVING COMMUNICATION WITH THE TAXPAYER

We believe the taxpayer experience and taxpayer relations can be significantly improved through better communications. TE/GE has made great strides in this area as the early implementer of the Service's practice of treating taxpayers more like customers than criminals. We support many of the current initiatives and recommend other initiatives, all as discussed below:

1. **Improved Web-based Tools.** *Establish a web-based audit process guide and other web-based tools.*

   We strongly support and urge completion and implementation of a web-based audit process guide. As we understand it, this guide will be for use by plan sponsors and practitioners to provide a "road map" as to what to expect from the audit. We think that a product such as this, with hyperlinks to other resources (e.g., audit guidelines, CPE materials, etc.) would be extremely valuable. We also believe an EP-focused Publication 1 "Your Rights As a Taxpayer" would also be helpful.

2. **Soft Contacts.** *Initiate audits through "Soft Contacts".*

   Often the first a taxpayer hears of an audit is through a letter announcing the audit. We encourage TE/GE to seek alternate means to initiate contact. For example, the EO division has undertaken to send taxpayers with certain types of errors on their returns a brief letter, noting that the return may be inaccurate on a specific issue, and then perform an audit only if the error is not corrected, or perform the audit the following year. Similarly, the EP compliance unit is in the early stages of developing appropriate treatment for matters they observe, such as sending a reminder letter to plans which fail to include a Schedule A with a Form 5500, or plans with 100 participants which still file a Form 5500EZ.

   With non-filers, the first contact could be a letter simply noting that no return was filed and asking for a copy of the return. Similarly, taxpayers give a better reception to a brief phone call to the taxpayer before the first letter is sent, or a letter with softer language. Accordingly, we strongly recommend the use of "soft contact" letters where appropriate, to determine whether a particular compliance problem exists.

3. Manage Taxpayer Expectations. *Set expectations early and simply.*

We hear anecdotal comments from taxpayers who have heard nothing from the Service for six months, then are asked to respond to a document request in ten days, or who have negotiated a settlement only to find it overturned on review. We encourage TE/GE to clearly communicate expectations to taxpayers at the onset of the audit. Taxpayers should receive a brief letter in plain English, outlining the areas being audited (if it is a focused audit), the anticipated timeline, and the demands expected to be placed on the taxpayer. For large cases this might take the form of a much more extensive meeting or series of meetings to agree on an audit schedule. Whether the case is large or small, we encourage TE/GE to contact the taxpayer personally to discuss these expectations. We also encourage the EP division to develop a brief letter or statement detailing the rights and obligations of both the taxpayer and the IRS.

It's extremely important to actively communicate with customers about delays and gaps in the examination process. Taxpayers deserve to know when a case is being delays for some reason, or why there is a period of long silence. Leaving taxpayers in the dark and guessing about status is poor taxpayer relations and heightens the adversity in the relationship. (See also discussion below, concerning the use of on-line tools in Active Case Management.)

4. Cooperative Approaches. *We encourage TE/GE seek more cooperative approaches, and in particular to adopt a practice of entering into audit contracts of the type implemented by the Service's LMSB division.*

Our vision here is that TE/GE would have an initial meeting with the taxpayer, identify topics to be audited and expected document needs, and then agree with the taxpayer on a schedule for completing the audit. For example, the taxpayer would agree to provide information with respect to each audit topic by a specified date, with a commitment by TE/GE to close each audit topic within a certain period of time after all documents have been produced.

5. Advance Notice of Actions. *We encourage TE/GE to provide ample advance notice of actions, such as IDRs, on-site visits, or actions requiring taxpayer response.*

A formal IRS document request can require document production within ten days, which is often unreasonably short. Audits often arise a year or more after the period or event under audit, when memories are stale and materials have been shipped to off-site storage locations, and large taxpayers may have voluminous documents and storage boxes to search for relevant material. With pre-contact planning, and an audit plan negotiated with the taxpayer, TE/GE should be able give the taxpayer enough advance warning about document

needs to avoid last-minute IDRs. Opportunities should exist for the taxpayer and the IRS to arrive at reasonable time frames within which information can be requested and submitted. For small cases, this could be managed through a phone call and confirming letter, rather than something as formal as a negotiated schedule.

We recognize that goals of reducing cycle time will discourage extensions of time to respond to document requests. Agents should not be penalized for providing advance notice of document requests, or for providing reasonable extensions of time to respond to document requests given with no advance notice.

6. Closing Processes. *We recommend TE/GE simplify closing letters and actively communicate general findings.*

We encourage TE/GE to actively communicate findings more quickly and reduce the delay between the final on-site visit or substantive communication and the final closing letter. We believe most taxpayers look for a simple assurance at the close of the audit that everything is in order, or specific corrections which are required. The Service's characterization of "no change" or "some change" is meaningless to unsophisticated taxpayers.

7. Communicating Common Errors. *We recommend EP prepare and communicate to taxpayers "top ten" lists of common audit problems, and "red flag" facts that suggest possible underlying plan problems.*

We encourage EP to publicize common errors and risk areas in order to increase compliance. Something like a "Top 10" list of common problems found on audit would be a good way of raising taxpayers' consciousness. There could be multiple lists – one for each major industry segment, such as a "Top 10 401(k) problems", a "top ten 403(b) problems" and a "top ten" defined benefit plan problems. We also encourage EP to prepare and publish a "red flag" list of plan design features or facts which indicate risk of deeper underlying problems. For an example, see Appendix A.

REDUCING CYCLE TIME

"Cycle time" is defined by the IRS as the period between the date of an auditable event (such as filing of an informational return) and the date an audit is completed. From the taxpayer's point of view, the "cycle time" is measured from when the notice of audit is received to when the auditor is out-the-door and the letter of no action is received. Long cycle times generate taxpayer dissatisfaction and impede effective audits as memories become stale or documents become difficult to retrieve.

The current pattern is for employee plan years that are two or three years back to be selected for audit. This may involve recovering files from storage. A more up-to-date audit would be preferable. For example, does the IRS have to wait for the return to work its way through the IRS system? Service practice is to scan Forms 5500, but it currently it takes approximately 1 ½ years for scanned Forms 5500 to become available to auditors.

We endorse the efforts of the EP Exam Reengineering group to reduce cycle time, reduce the burden on taxpayers, and achieve better case selection. Some of our comments below are drawn from or in response to our understanding of the early efforts of this redesign team.

Below are a number of suggestions for reducing the length of time in a typical audit cycle.

1. Case Selection. *Employ techniques that focus examination selection on the most likely problem cases.*

The initial selection decision is an important step in audit efficiency. Careful case selection can minimize the amount of taxpayer and TE/GE time spent on audits which don't uncover any compliance failures. In the recent past, the percentage of employee plan audits closed without a change has equaled approximately 70%. We recognize the resources available to conduct audits are limited. We believe better targeting of cases for examination will further the goal of identifying and correcting non-compliance. We support EP's recent efforts to improve, refine and expand the use of the "risk assessment" technique for audit case selection. We encourage EP to continue to refine its risk assessment approach, and consider criteria such as whether specific industries have weaker compliance records, specific problems common in certain industries, the type of plan, past audit experience, 5500 errors, and specific vendor problems.

2. Pre-Contact Planning. *Plan the audit prior to any contact with the taxpayer.*

Before engaging with the taxpayer, TE/GE should make every effort to prepare for the audit. This could include careful review of information on the return, identifying and reviewing information available from other resources, reviewing the Internal Revenue Manual and relevant legal authority, determining audit scope, and preparing document requests where appropriate. During this pre-contact planning stage, TE/GE can consider whether a limited scope audit or correspondence audit would be more appropriate for the specific case. Part of this planning should include adequate time to request, receive and review documents prior to any on-site visits. This is also an appropriate time to consider agent selection, and whether the case might be suitable for agent training and development. To the extent that involvement of IRS Counsel may be important,

we encourage TE/GE to identify those issues during the pre-planning stage and coordinate with counsel's office to ensure timely turnaround on those issues. Initial data requests are often broad and cover a standard list of documents and information, sometimes requesting unnecessary documents or copies of materials which the Service should already have. We encourage the TE/GE require agents to prepare accurate and focused data requests.

3. Focused Audits. *Develop programs to expand the use of "focused" or "limited scope "audits.*

We also believe there are potentially greater efficiencies available through the expanded use of "limited scope" or "focused" audits – audits which target a select number of issues. By identifying a limited number of audit issues during the pre-contact planning stage, TE/GE can narrow the initial inquiry, leading to faster document production and faster resolution of those issues. A necessary companion to this is to prepare a narrow and targeted request for documents and information. While we recognize the TE/GE needs to retain the ability to expand the case to include other issues, we would recommend that any expansion beyond the initial limited scope be undertaken only with management approval.

We also recognize that newly hired agents may not have the experience to identify when a limited scope audit should be expanded. Rather than limit the focused audit approach to more senior agents, we would encourage TE/GE to prepare junior agents with proper training, and exercise closer supervision when a junior agent is assigned to a limited scope audit. One training aid might be a "Red Flag" list of ways to identify problems. (See example in Appendix A.) Such a list might also be useful to plans as well, to help identify problems and cure them well before an audit. It might be appropriate to have different lists for different plan types (403(b), 401(k), defined benefit, multi-employer), or even for different industries.

4. Different audit techniques for different case types. *Continue to apply alternate audit approaches, and in particular to implement joint agreements with taxpayers in large cases.*

Different audit approaches can and should be applied under different conditions. Variables such as the taxpayer's size, history or industry may warrant a different approach. It's often possible to handle small cases entirely through correspondence. We understand TE/GE recently established the Employee Plans Team Audit program, EPTA, aimed at plans with 2,500 or more participants. The key features of the program are planning, engagement, management involvement (IRS manager), and post-audit critique. We applaud the use of the team audit approach for large cases. For large cases, TE/GE should implement a program of negotiating audit schedules with the taxpayer,

implementing the cooperative approaches discussed above in the context of Communication with the Taxpayer.

5. Agent Selection. *Match cases to agents based on expertise, not geography, and actively manage agent inventory.*

Historically, agents have been assigned to cases in large part based on geographic proximity, following an audit model founded on site agent visits. As a result, agents may be auditing cases involving issues for which they have no experience, or beyond the agent's expertise. We believe audits will be concluded faster and with greater efficiency for both TE/GE and the taxpayer if the auditor has specific experience with the type of issues under audit. We recognize that matching the agent to the case may not always be possible within a single geography, and encourage TE/GE to carefully consider the opportunities to conclude an audit more efficiently, despite the additional travel costs of bringing in an auditor from another geographic area.

We encourage TE/GE managers to actively review and manage agent caseload. Regular review of an agent's caseload will help ensure that the cases continue to move forward expeditiously, and should allow the manager to identify problems in advance of overburdening the agent. An auditor forced to conduct too many audits simultaneously may be unable to move individual cases quickly, yielding low close rates and contributing to taxpayer dissatisfaction. In addition, as the case stretches out over time, the auditor will spend additional time reacquainting himself or herself with the issues each time new action is required. We also encourage TE/GE to keep inventory at manageable levels, to allow agents to work cases more frequently, reduce cycle time and thereby increase throughput and decrease customer dissatisfaction with long cycle times.

We recognize that auditors often gain expertise by being assigned to cases which require the auditor to learn new areas, and that this training objective may be in conflict with the objective of achieving efficiency by matching auditors to cases based on expertise. We encourage TE/GE to continue to support this training objective by carefully matching auditors to cases with growth opportunities, but under the guidance of a manager with the necessary expertise.

6. Agent Training. *Devote significant resources to training examination agents.*

The number of EP examination agents dedicated to processing examinations has increased from approximately 300 in 2003 to approximately 550 at the beginning of 2004. Encourage TE/GE to hire more In addition, the anticipated shift of EP personnel from the Rulings and Agreements group to the Examinations group will increase the number of agents new to examinations. We encourage TE/GE to devote significant resources to training new examiners during the period of transition. We also encourage TE/GE to work with outside resources to develop

training materials. Attorneys and accountants experienced in responding to audits may be among the best resources to help train new auditors.

7. Active Case Management. *Actively manage cases and caseloads by establishing guidelines and norms for the amount of time a case should take, monitor agents' progress frequently, and consider use of on-line tools and administrative staff to monitor time lines.*

We recognize that each case is different and may require different resource and time commitments. However, we believe that there should be enough common elements to set reasonable norms and guidelines for how long a case should take, particularly small cases or cases handled via a correspondence audit. We encourage TE/GE to establish guidelines and norms for the amount of time a case should take, and monitor agents' activities frequently and at a depth necessary to detect timeline problems well before the case starts exceeding the norms. We also encourage TE/GE to develop on-line status information, and make that available to the taxpayer and the taxpayer's advisor(s), such as through a PIN-controlled login. This would help improve cycle time management by giving the taxpayer an opportunity to monitor status, and would also enhance communications between TE/GE and the taxpayer. We recognize that this could develop into just another burden, and would encourage TE/GE to develop the system in a way which would allow it to substitute for existing tracking processes, and use it both internally and externally.

8. Coordination with EPCRS. *To the extent audit cycle time is improved by initiating audits early, EPCRS should be modified.*

EPCRS currently provides a different fee structure and process for plan defects identified on audit, compare to plan defects identified and corrected by the plan or plan sponsor. We recommend that EPCRS be modified to allow certain audit-identified problems to be handled without the higher fees and penalties. Typically, plan sponsors may not identify a plan defect until the next annual recordkeeping cycle. If an audit commences before that cycle is complete, the plan will have been denied the opportunity to rectify the problem through self-correction or a plan-initiated filing under EPCRS. We recommend that EPCRS be modified to state that allow corrections to be treated as taxpayer-initiated if the correction is in response to an audit which commenced within 18 months after the end of the plan year or if the taxpayer had already identified the potential problem and commenced an internal review within the 18-month period.

8. Access to Forms 5500. *We encourage EP to consider using outside services, such as freeerisa.com, to access and process return information quickly.*

Auditors may not have access to Forms 5500 for approximately 1½ years after filing, due largely to delays in the process for electronically scanning and disseminating the forms. We encourage EP to consider using outside services such as freeerisa.com, to process and access Form 5500 information. EP may also wish to consider commencing an audit based on a prior year return, and requesting the latest return from the taxpayer.

OTHER SUGGESTIONS

We have two other suggestions which don't directly affect communications and cycle time, but which we believe deserve mention here.

1. Audit practices should be consistent nationwide. We believe consistency is an important element of fairness in any examination program. For this reason, we recommend that EP continue to devote resources to publishing "Audit Guidelines" for use by agents and plan sponsors. These guidelines should be kept up-to-date, and ideally will allow taxpayers to conduct self-audits as well has help prepare for audits initiated by TE/GE.

2. Identify means to review third-party providers. We believe that on occasion the practices of third parties should be targeted in audit and compliance reviews, and remedies sought against those third parties. This is an aspirational objective, and one that may require legislation. Many taxpayers rely on vendors to manage significant parts of their programs. Smaller plans, and even many large plans, rely heavily on third party recordkeepers or recordkeeper-trustees to establish and operate their retirement plans. These taxpayers may have only superficial understanding of the requirements to which they are subject.

Competition pressures vendors to provide services as lower costs. Less scrupulous vendors will take advantage of the relative lack of experience of their clients by promising lower costs and providing limited or shoddy service, with the taxpayer bearing the responsibility for compliance defects.

When clients of a particular vendor are experiencing high rates of non-compliance, we believe that the vendor should be targeted for a review of the vendor's practices and policies, where the vendor's practices have created or contributed significantly to the problem.

For example, where a retirement plan recordkeeper provides distribution notices or 402(f) notices which are defective, some penalty should accrue to the recordkeeper, rather than to the unsophisticated plan sponsor who relied on the recordkeeper's expertise.

TE/GE can initiate a civil investigation under Section 6700 (promoter penalties) or Section 6701 (aiding and abetting penalties), make a referral to the IRS Office of

Professional Responsibility, or refer the matter to Criminal Investigation (CI). We believe TE/GE should consider using these tools more broadly, looking at systemic errors and patterns of poor compliance. We encourage TE/GE to train agents in use of these enforcement tools, and ensure that training is in place so that agents can take appropriate action.

Where EP has identified process defects, EP should work with the vendor to correct the process. Compliance is the objective, not punishment.

TAX-EXEMPT BONDS

General Overview of Tax-Exempt Bond Examination Process

A formal audit program for tax-exempt bond issues was not initiated until 1993 and was created in response to a General Accounting Office report[1], which criticized the Service for relying too heavily on self-enforcement of tax-exempt bond regulations. The GAO report directed the Service to develop a formal enforcement program for tax-exempt bonds and specifically required the Service to address possible abusive transactions in a timely manner.

An audit of a tax-exempt bond issue possesses unique characteristics.

First, the issuer of the bonds is not the taxpayer. In the event of a determination of taxability, the bondholders are responsible for the payment of taxes, not the issuer of the bonds. However, bondholders generally do not have any information to assist in the examination process. Instead, the issuer or the conduit borrower maintains all records relating to the bond transaction and the underlying legal documents. This creates a unique complexity to the audit process for TEB. To address this problem, the audit guidelines treat the issuer of the bonds as the taxpayer for purposes of performing an examination.[2] Issuers are entitled to administrative appeal, but in most cases judicial review of IRS determinations must still be initiated by bondholders. IRM Section 4.81.1.17 allows a judicial review of certain determinations under Code Section 150. As a practical matter, this means that it is extremely rare that any issues raised on an audit of tax-exempt bonds are ever reviewed by an independent third party.[3]

A second area of concern with respect to the audit of tax-exempt bond issues is the municipal bond marketplace reaction to an issuer's disclosure that an issue is under examination. One study[4] performed by an industry organization concluded that there

[1] GAO/GGD-93-104
[2] See IRM Section 4.81.1.11.
[3] Legislation would be required to allow issuers the ability to seek a judicial review of an adverse determination.
[4] The Bond Market Association: "Secondary Market Effects of Municipal Bond Tax Audit Disclosure" – August 20, 2002

can be a decrease in the market price of variable rate bonds, at least in the short-term, when the market has knowledge of an examination in process for a particular bond issue. It should be noted that this study was not conclusive as to the impact on fixed rate debt.

In response to this possible market reaction, TEB developed several versions of the audit notification letter that explains to the issuer the reason the issuer has been selected for examination. It identifies the selection as either being a random audit, an audit in response to certain information that has come to the Service's attention, an audit being conducted because the bond issue has certain structural components that the Service wants to examine (e.g., open-market escrow, guaranteed investment contract, etc.), or is a type of bond that the Service is trying to obtain more compliance information about the type of issue (e.g., student loan bonds). It is not certain whether this clarification of the audit selection in the notification letter has had any impact to market reactions, but we believe this was an appropriate and helpful change to the TEB examination process.

A third issue relates to the timing for starting the audit. Certain tax compliance matters, such as the structure of the bond issue, costs of issuance paid, and in many cases arbitrage restrictions, can be determined at the time the bonds are issued or within a few months after the date the appropriate Form 8038 is filed with respect to the bonds. Other tax compliance matters, such as the use of the bond proceeds and the use of the facilities financed with the bonds, frequently will not be auditable until several years after the bonds are issued and in many cases actions taken by the issuer 20 years after the date the bonds have been issued can cause the interest on the bonds to be included in federal gross income from the date the bonds were delivered. This timing issue can create problems for the Service in deciding when to initiate an audit on a bond examination and can create record retention and institutional memory problems for issuers and conduit borrowers, who may be required to maintain records for the entire 30-year life of a typical bond issue (plus six years) and who often will have no one around who remembers the facts relating to a particular bond issue.

Consistent with many other areas in TE/GE and in the IRS generally, TEB also has a manpower issue. There are between 12,000 –15,000 tax-exempt bond issues sold in the country annually. The TEB division generally has an average of 400 examinations in process at any point in time. Currently, there are less than 40 agents performing audits of tax-exempt bond issues.

Moreover, because of the complexities involved in examinations of bond issues, TEB only utilizes experienced agents. These agents are internally trained in a series of courses specific to tax-exempt bonds. New hires into TEB go through a three-to-four week course of initial training in the area. All agents also received technical examination training about bonds and receive ongoing specialty training with respect to areas of potential abuse or non-compliance.

Under current TEB practice, tax-exempt bonds are selected for examination from a number of sources, including: (1) referrals from third parties, (2) transaction features

previously identified by TEB personnel as having a higher likelihood of possessing abusive features (sometimes involving Section 6700 violations), and (3) random audit selection of a particular bond issue type or attribute.

In addition, TEB has undertaken a number of projects for the purpose of better understanding the compliance levels of a certain type of financing (e.g., single-family bond issues). TEB assigns agents to look at the defined transactions, develop check sheets to assist in establishing audit guidelines, and forward their findings to the Office of Outreach, Planning and Review (OPR). The agent(s) assigned to defined projects will generally write an article to be used as part of the training of TEB agents. OPR utilizes all of the information gathered from these defined projects to determine the best approach to encouraging issuer compliance.

The ACT has previously identified IRS audits as being a necessary component of encouraging compliance and self-correction.[5] The audit process performs at least a three-part role. First, the existence of an audit program, with appropriate penalties for noncompliance, provides additional incentive for users of tax-exempt bonds that are otherwise motivated to comply with the law to determine exactly what the rules are that are applicable to them and to try to satisfy those rules to avoid penalties. Second, the audit program gives the Service the opportunity to identify areas of noncompliance and seek to remedy those areas by either providing additional guidance (where the law is clear) or by seeking to have the rules clarified, either through issuance of regulations or rulings or through sponsorship of legislation (where necessary). Third, the audit program can be used to identify and select for appropriate treatment those few individuals who operate either with reckless disregard or with intentional disregard to existing law. Section 4.81.1.2 of the Internal Revenue Manual states that the goals of the tax-exempt bond examination program are to achieve significant levels of pre- and post-issuance compliance, respond promptly to abusive transactions, increase the effective use of informational returns, encourage transaction participants to take an active role in ensuring that their bond issue comply with the law, and promote voluntary compliance. We continue to believe that the "feedback" role of the examination program—to identify areas of noncompliance to direct educational initiatives and to help determine where the law needs to be developed more fully—remains a vital part of the program.

At the same time that the audit program is helping to accomplish these positive goals, the audit process can have negative effects. The audit itself may often be an extended process, where the entity being audited may have little idea as to what to expect as to the time involved and the issues being audited. During the course of the audit, there may be extensive periods of time during which there is no contact with the agent and the issuers or conduit borrowers may have no idea what is going on at the IRS on their cases.

In addition, the uncertainty on the part of the audited entity can be exacerbated by the knowledge of the issuer that it may have little recourse in the event of an adverse determination by the agent. As mentioned above, the Internal Revenue Manual treats

[5] General Report of the Advisory Committee on Tax Exempt and Government Entities dated June 21, 2002.

issuers as taxpayers for purposes of examination. In addition, beginning in September 1999, issuers were given the ability to request an administrative appeal of a proposed adverse determination to the Office of Appeals.[6] However, once the audit is complete, the issuer has no obvious method of obtaining a review of an adverse determination outside of the Internal Revenue Service (e.g., a court review of the result). In certain cases conduit borrowers may be also be treated as taxpayers (for example, under section 150(b) or section 168 of the Code) allowing for a collateral review of the adverse determination as to the status of the interest on the bonds. However, the issuer generally does not have the right to have the tax status of the bonds reviewed by a third party. Accordingly, where the experience of the issuer in the audit is poor, the issuer may be less inclined to be comfortable with a review of the audit internal to the IRS.

Suggestions for Improving the Audit Process:

The efficiency of the TEB audit process, the effectiveness of the auditor, and the experience of the audited issuer or conduit borrower can be improved by better communication between the auditor and the issuer and by managing the cycle time of the audits. This report suggests some tools that can be used toward this end. Some of these tools have been at least partially implemented by TEB, while others have been borrowed from practices either already in use or being considered by other divisions. We commend TEB for implementing some of these practices and encourage a wider acceptance and development of these tools.

A. Communication with Taxpayer[7]

1. Treat conduit borrower as taxpayer for purposes of audit.

Because of the nature of tax-exempt bonds, the only true taxpayer involved in most transactions is the owner of a tax-exempt bond. The IRS has long recognized that the owner of a tax-exempt bond is unlikely to have most or perhaps even any of the information relating to whether the bonds qualify for tax exemption and is unlikely to have the resources to marshal information relating to any legal theories involved with respect to a bond issue. Accordingly, the Service determined some years ago to treat the issuer of the bonds as the taxpayer for purposes of the examination.[8] This treatment is necessary to allow the examination process to obtain any useful information.

In many cases, however, the issuer simply acts as an accommodation party in issuing the tax-exempt bonds and the real user of the bond proceeds—and the person possessing the facts necessary to determine compliance—is the "conduit borrower." In addition, in most cases the conduit borrower has undertaken to maintain the tax-exempt status of the bonds and has indemnified the issuer against any tax problems. Thus, in

[6] Revenue Procedure 99-35.
[7] Because the issuer is treated as a taxpayer for purposes of a TEB audit, this paper will refer to issuers as "taxpayers."
[8] Announcement 95-61. See IRM Section 4.81.1.11.

cases involving conduit borrowers, it would appropriate for the examining agent to be dealing directly with the conduit borrower rather than the issuer.[9]

Accordingly, we would propose that TEB adopt a rule that would treat the conduit borrower as the taxpayer for purposes of the audit. This could be done by amending the Internal Revenue Manual, if possible. In addition, it would be appropriate to amend the Form 8038 to ask for the name, address, and TIN of the conduit borrower and for a contact person or contact position at the conduit borrower (in all cases except for the portfolio financings accomplished using student loan bonds and single family housing bonds). We understand that this suggested change is already in process in connection with the revisions of Form 8038.

2. Opening contact; manage the issuer's expectations by discussing timelines and the audit plan.

At the request of issuers, investment bankers, and the bondholder community, TEB has developed three forms of initial contact letters. These contact letters are designed to inform the issuer as to general reason the bonds have been selected for audit so the issuer may meet its on-going disclosure responsibilities.[10] Unfortunately, however, neither the initial contact nor any later stage of the audit includes a discussion with the issuer as to what to expect from the audit. Because issuers have not historically been subject to audit, they may have unreasonable or unrealistic views as to the scope and the timetable for the audit.

It is important to manage the issuer's expectations to keep the issuer from becoming frustrated with the process of the audit. We recommend that the issuer be given an outline of the expected course of the audit, including estimated timelines. Obviously, the audit may vary from that outline as the case develops. However, by providing an initial outline to the issuer and keeping the issuer up to date as timeline or scope changes, the Service can forestall issuer concerns that arise from unrealistic expectations.

Under the IRM, agents involved in the TEB examination program are to perform pre-examination research and prepare a comprehensive audit plan.[11] The audit plan might be a good starting place for developing a plan or outline that could be shared with the issuer or the conduit borrower. The form of the outline could either be in written material contained in the initial contact letter or in the first IDR or could be presented at an "opening meeting" or conference call designed to set expectations.[12] To the extent

[9] In the case of so-called "blind pools," where the conduit borrowers have not been identified at the time of the closing, the Service should continue to conduct the examination directly with the issuer.
[10] See IRM Section 4.81.1.14.1 and the sample letters contained in Exhibits 4.81.1-3, 4, 5, and 6 to the IRM.
[11] IRM Sections 4.81.1.12 and 4.81.1.13.
[12] We understand that in some cases EP has been considering or experimenting with an "audit contract." TEB may want to explore the success of such a procedure to see whether it could be adapted to tax-exempt bonds.

that particular legal or factual issues will be involved in the audit that can be identified at the time of initial contact, these could be conveyed to the issuer at that time.

3. Keep taxpayer advised as to timing for next step.

From the point of view of the issuer or conduit borrower, the audit process sometimes seems to be poorly focused and completely open-ended. Frequently, several months pass between communications from the IRS. Additionally, there may be several Information Document Requests (IDRs) requested every few months along the way. The IDRs contain specific deadlines by which the issuer should respond (although the agents will fairly readily allow an extension of those deadlines), but the issuer has no idea what the schedule of the agent is, ~~or~~ when the next IDR might be received, or how many IDRs may be issued. To the issuer, this process can be very frustrating.

We recommend the Service provide the taxpayer with an initial overview of the audit process as a means of establishing expectations for the taxpayer as to how the examination will progress. In addition to providing a general audit plan or overview of the process, another way to improve the examination process for the issuer would be to give the issuer some idea of when responses or additional inquiries will be coming from the agent. It may not always be possible to establish absolute deadlines, but giving the issuer some idea of when it will next hear from the agent will at least reassure the issuer that the agent is actively working the case. We believe that increased communication with the taxpayer will reduce uncertainty, tension, and frustration and will improve the overall effectiveness of the examination.

B. Reducing Audit Cycle Time.

One concern shared by both the IRS and the issuers is the amount of time involved in conducting an examination of a tax-exempt bond issue. The Service has established a goal of trying to reduce audit "cycle time."[13] Issuers (and bondholders), similarly, are interested in bringing any examination and the concomitant disruption in its affairs and the market for the bonds to a close as quickly as possible. The ACT fully endorses the goal of reducing audit cycle time, although we agree with comments made by the Director of TEB to us to the effect that the goal of decreasing audit cycle time should not take priority over performing an appropriate examination and resolving violations of the tax law. In particular, in intentionally abusive situations, we believe that it is more important to "solve the problem" and send a message to potential abusers than to try to bring the examination to a swift conclusion.

[13] The Service often refers to cycle time as the time from the filing of the return until the completion of the examination. As described above, where tax-exempt bonds are involved, it may be necessary to delay the start of the audit for some time to allow the facts to develop. Accordingly, from the issuer's point of view, a more useful measurement is the time of the "intrusion" of the audit—that is, the period that starts with the receipt of the opening examination and that ends with the closing letter or the signing of a closing agreement by all parties. For purposes of tax-exempt bond audits, we will refer to the cycle time in the latter sense. This is consistent with how cycle time is measured by TEB.

With that in mind, however, we have a number of suggestions that we believe would help to move examinations along more quickly. TEB has already identified some of these problem areas and has taken initial steps to improve cycle time. We commend TEB for taking these initial steps, and encourage further development in these areas.

1. Selection of cases.

In our discussions with the Director of TEB, one of the primary problems identified with the TEB examination program is the difficulty of understanding the complex structures of tax-exempt bond issues and applying what may often be multiple sets of rules to the details of the transaction. We agree that tax-exempt bond transactions can often be complex and one transaction may vary from another seemingly related transaction by a myriad of details. It takes substantial training and experience to learn to quickly separate the important variations in a transaction, the variations that may actually have a tax law impact, from the multitude of other variations that may be important for business reasons but may not have any tax law impact. The next two recommendations are designed to try to develop greater expertise among the agents.

TEB has established procedures for the selection of cases.[14] In large part, these procedures focus on various information gathering projects, compliance initiatives, and referrals. As a result, an agent starting to work on an audit may have little or no experience in the particular rules applying to those types of bonds. In addition, there may not be adequate training materials available relating to the particular type of bond issue being audited. The consequence of this lack of knowledge, either individual or institutional, can result in an extended examination.

Although TEB should not solely select for examination bond issues that involve information or expertise that it already possesses, to the extent that cases are selected for which TEB has developed adequate training materials or are related to subject matters which the agent already knows about, the audit process can be accelerated. According to the director, TEB has recently considered one of the early steps in initiatives involving information gathering to be the development of training materials relating to that topic. We encourage TEB to continue to develop training materials early on when it undertakes examination of a number of related bond issues. In addition, as experience develops from those audits and agents learn how to best approach an examination of a particular type of bond issue, that knowledge should be incorporated into the training materials to shorten future examinations.

We recognize that case selection is also dependent on the number of available agents to perform examinations. Currently, TEB has less than 40 field agents to perform examinations. There are also a significant number is potential cases identified for examination, including many cases which might be considered abusive transactions. Since the GAO issued a directive to focus on abusive transactions in a timely manner, most of the available TEB agents are assigned cases involving a potential abuse.

[14] IRM section 4.81.1.5.

2. Assignment of agent.

In addition to developing the training materials relating to particular topics, it is important to develop the individual expertise of the agents. In the private sector, the expertise of the individual practitioner is honed by working on several related matters. For example, the same tax associate might be assigned to several multifamily housing transactions in a relatively short period of time. In this manner, the associate develops skills to identify and resolve potential issues in a relatively short timeframe.

Similarly, TEB should be encouraged to develop the expertise of individual agents by assigning agents who have completed audits involving a particular type of bond issue similar bond issues. TEB is using its Special Training program to develop expertise in particular areas. We believe this is an extremely valuable program, and TEB is encouraged to continue this program and develop it further. Pursuant to the IRM, Field Group Managers are delegated the responsibility of assigning cases to field agents.[15] Field Group Managers should be encouraged (to the extent they are not already doing so) to take into account the prior experience of agents in making their assignments.[16] In addition, field agents should be encouraged to speak with other agents who have audited similar issues

3. Pre-contact planning phase.

The IRM states that an agent should normally perform pre-examination research on every case to avoid or reduce the potential market impact of an examination.[17] In addition, pre-contact research and planning can reduce the time for the examination if the agent takes the opportunity to prepare him or herself for the examination. The agent should be encouraged to review not only any IRS training materials relating to the subject matter of the investigation, but also the particular requirements set forth in the sections of the Code and regulations involved in the financing. In addition, an agent may find it useful to refer to materials published by third parties relating to that type of financing. A useful source, for example, would be referring to copies of the textbook from NABL's annual Bond Attorneys Workshop. Often, the BAW textbook will contain outlines relating to the specific issues raised with a particular type of financing. Other resources from NABL can be useful, such as the outlines from the Arbitrage or Tax Seminars or Institutes. (We understand from discussion with the Director of TEB that the last part of this recommendation was implemented during 2003 when TEB purchased the Bond Attorneys Workshop books for internal training purposes.)

[15] IRM Section 4.81.1.5.3.2.
[16] IRM Section 4.81.1.9.1.1 specifically states that the group manager will assign cases to agents taking into account the experience of the agent. Group managers should be encouraged to take into account not only the overall amount of experience of agent, but also the specific experience of the agent with related cases.
[17] IRM Section 4.81.1.12.

4. Consider narrow scope of examination.

In some cases, an examination may be opened to focus on a particular identified substantive issue, rather than a more broad inquiry relating to all tax issues that could relate to the bond issue. Where the Service has identified a particular recurring compliance issue, such "narrow scope" examinations should be encouraged in the place of the "soup to nuts" examination. A sufficiently focused examination should proceed substantially quicker than a broad examination.[18]

TEB has undertaken these narrow examinations in the past. For example, a large number of examinations are done focusing solely on arbitrage issues.[19] Similarly, TEB has done focused examinations of solid waste disposal facility bonds, looking at whether the definition of "solid waste" is met, and is undertaking a series of examinations of advance refunding bond issues that involved the sale of "escrow puts" by the issuer.

It should be noted, however, that as with all examinations, the narrowly focused examination can be substantially bogged down if the examination is into an area where the law is not yet settled. If the examination process unearths substantial issues related to unsettled law, it is important that the law be clarified in a principled manner that is satisfactory to both the IRS and to the industry. For this reason, where unsettled areas are found, we recommend that the Chief Counsel and Treasury, if necessary, become involved to provide additional guidance. A recommendation by TEB that particular issues be resolved by regulation or other published guidance would be perceived by the bond industry as evenhanded enforcement.

On the other hand, to the extent that the law is settled and on-going compliance problems are identified, TEB should be encouraged to use the narrow examination route more frequently.

5. Case management.

One important tool to encourage a timely audit process is case management by TEB. Under the current guidelines, quarterly reports are made by each group manager relating to on-going examinations.[20] This procedure is designed to provide information to TEB management relating to the process of cases. We endorse a reporting procedure, and believed it can be enhanced by providing additional parameters.

- Estimates should be made as to how long a particular examination will take when the examination is opened. The estimate should be consistent with the audit plan conveyed to the issuer at the opening of the examination. Progress reports can be measured against these estimates and, if necessary, the estimates can be revised. If the examination is

[18] We have been informed that EP is exploring using a similar "narrowed scope" examination process.
[19] In many cases, arbitrage issues can be also relatively easier to audit once the basic arbitrage questions are understood.
[20] IRM Section 4.81.1.26.

delayed and the schedules are revised accordingly, management of TEB should know why the examination is delayed and use that information to identify particular problems with the original estimate, with the particular bond issue under examination, or with the expertise of the agent.

- With enhanced scheduling information, both group managers and the Director will be better able to "stay on top" of the agents. When cases are delayed due to training or expertise issues, it should be easier to identify those issues and to take curative measures.

- Finally, it is important that case management issues be delegated to positions that require less substantive skills (such as administrative assistants or secretaries) unless and until there are problems that result in substantial delays. That is, where systems are working as expected, it should not be necessary to bring management into the picture. This should give managers more time to use their skills to manage problems.

6. Closing procedures.

One anecdotally reported complaint among issuers who are audited is the time it takes to close an examination. In some cases, a letter closing a case with no change may be received months after the last contact with the Service. When a case is closed through a closing agreement, it may be months after the closing agreement is signed before the issuer receives formal notification of the closing of the case. This delay in bringing what is thought to be a closed matter to completion can be very frustrating to an issuer, particularly where the pendency of the examination has been disclosed to the public by the issuer in order to comply with SEC rules or with good disclosure practice.

The case closing procedure is spelled out at some length in the Internal Revenue Manual, at Section 4.81.1.32. We encourage TEB to examine the closing procedures in some depth to see what can be done to make the closing process smoother. In addition, more priority should be given to getting cases actually closed in a timely manner.

7. Issues beyond the control of TEB.

A number of other issues that are beyond the control of TEB contribute to a slower audit cycle. In large part, these boil down to resources problems. The staffing level of TEB is currently about 60% of the suggested staffing level and is down to about 70-75% of recent staffing levels. Often there is a substantial delay in getting technical advice from the Chief Counsel's office; again, additional staffing at the Chief Counsel's office could help with this bottleneck. We encourage the review of resources and consideration of allocation of additional personnel to TEB and the Chief Counsel's office.

8. Soft Guidance – Reporting Findings.

We believe that educating the issuer community to the types of errors found during examinations of tax-exempt bonds that have a positive impact on future errors by other issuers. We recommend TEB develop a "Top 10" listing (or similar title) detailing the nature of the errors encountered during tax-exempt bond examination to be used as a training tool for agents. This list can be incorporated into the CPE material published on the TEB web site thereby providing an education tool for the entire tax-exempt bond community.

9. Records retention as an audit issue.

Finally, although not directly related to audit cycle time, a particular audit issue that has become very important to issuers is records retention. For bonds to be tax exempt, various rules must be complied with over the life of the bond issue. The issuer must identify how the bond proceeds were spent or to what particular expenditures the proceeds were allocated. The issuer needs to keep records as to investment of all proceeds prior to expenditure, including records as to investments and expenditures from any reserve funds or debt service funds. The issuer needs to show how any financed facilities were used over the life of the bond issue, including rentals of space in bond-financed facilities, management contracts, sales of output, and the like. For particular types of private activity bonds, the conduit borrower or issuer may need to keep specific records—for example, for a multifamily housing project, records need to be kept on the incomes of tenants and the rental of units. Over a thirty-year bond life, the volume of the original records that need to be kept can become enormous.

In addition, because of turnover at the issuer or conduit borrower, the institutional knowledge relating to the bonds and the bond-financed projects may become diluted or lost. Even if records are kept, it may become difficult or impossible to identify the importance or location of the records.

The costs of maintaining the records and the institutional knowledge can become quite burdensome. Issuers have been complaining for some time about the costs and burdens of record retention. The records retention problem becomes especially acute in the context of an audit, where it is quite common for the agent to issue an IDR asking for records relating to all expenditures of bond proceeds. Although an issuer may have available trustee records, those records often are not accurate or reflect expenditures that on a "direct tracing" basis are different from the allocated expenditures made by the issuer under Treasury Regulation §1.148-6.

The committee believes that the Service must take steps to address the records retention problem. One possible solution, suggested in our VCAP report, is to provide for a "self audit" (either internal or external), after which only the audit needs to be kept and the primary source material may be discarded after a reasonable period of time. This is similar to plan sponsors being required to obtain an audit in connection with the filing of Form 5500. Issuers of tax-exempt bonds could be given the option of an audit of the related records of a bond issue.

Other solutions may be available, and we highly encourage TEB to contact various industry groups, such as GFOA, and work with Chief Counsel's Office and Treasury to develop a more formalized program to simplify the record keeping the requirements. Such a program would help to make the examination process more efficient from the Service's point of view and less painful from the point of view of the issuer.

APPENDIX A

401(k) "Red Flag" List

Sample "Red Flag" list for a 401(k) Plan. Such a list could include issues which can be identified with some general information about the plan sponsor and a review of the plan document and summary plan description.

1. Compensation Definition

Definition of Compensation for purposes of applying deferral elections ties to W-2 compensation, and the plan sponsor has a stock purchase plan or broad-based stock option plan.

Equity compensation plans typically generate W-2 income on exercise of stock options or early sales of stock purchased through a §423 stock purchase plan. A plan which permits employees to make 401(k) deferrals from such income may not have any means to collect the deferred income, and therefore would be applying the deferral percentages incorrectly.

2. Definition of Eligible Employee

The plan does not exclude persons classified by the employer as non-employees, and the employer hires temporary employees and "independent contractors".

Many plans exclude so-called leased employees, but may not exclude persons classified by the employer as non-employees. A company which hires large number of temporary employees and "independent contractors" may in fact have many common law employees who are misclassified. Broadening the audit to encompass an examination of such persons designated as independent contractors may in fact uncover common law employees who have been improperly excluded, or former leased employees who are entitled to past service credit after having been hired as regular employees.

3. Deferral Percentage Tests

The plan does not provide for matching contributions and does not limit the percentage which may be deferred by Highly Compensated Employees.

Many plans pass the average deferral percentage test by limiting the contributions of highly compensation employees, or encourage higher contributions by Non-Highly Compensated Employees through the use of matching contributions. Other plans may return excess contributions, or make supplemental non-elective contributions in order to pass the ADP test. If a plan has no limits on HCE deferrals and no matching contributions, broadening the audit to examine how the plan meets the ADP test may uncover a process inadequacy.