

**Establishing Case Priorities and Enhancing
the Processes Would Improve the Employee
Plans Efforts to Resolve Reported Funding
Deficiencies on Form 5500**

September 2004

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

September 30, 2004

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Gordon C. Milbourn III

FROM: Gordon C. Milbourn III
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Establishing Case Priorities and Enhancing
the Processes Would Improve the Employee Plans Efforts to
Resolve Reported Funding Deficiencies on Form 5500
(Audit # 200410010)

This report presents the results of our review of funding deficiencies reported on the Annual Return/Report of Employee Benefit Plan (Form 5500). The overall objective of this review was to determine whether the Tax Exempt and Government Entities (TE/GE) Division processes ensured the funding deficiencies reported by defined benefit and defined contribution pension plans were appropriately resolved. The Employee Retirement Income Security Act (ERISA) of 1974¹ establishes the minimum annual funding amounts that employers must contribute to pension plans in an effort to ensure pension plans have enough money to pay benefits when due. If the ERISA minimum funding requirements are not met, the underfunding is reported on the Form 5500 return.

Pension underfunding has recently become a greater concern. For example, in 2002, 320 companies in the Standard & Poor's (S&P) 500 Index had defined benefit pension asset losses of \$106 billion.² However, pension asset levels are only one factor used in determining whether pension plans are meeting the ERISA minimum funding requirements; therefore, plan sponsors are generally not required to offset all pension

¹ 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.).

² 2003 *Corporate Funding Survey on Pensions (FASB 87)*, issued May 14, 2003, by Wilshire Associates Incorporated. This study covered defined benefit plans sponsored by S&P 500 companies, based on a survey of 320 companies in the S&P 500 Index that maintain defined benefit plans.

asset losses with corresponding contributions to the plans. In 2002, plan sponsors responded by making contributions to their pension plans totaling \$41 billion.

Under the ERISA, the Department of Labor and the Department of the Treasury jointly have the authority to issue regulations and ensure the ERISA is enforced. The Pension Benefit Guaranty Corporation monitors the adequacy of pension plan funding to determine if a plan may need to be terminated immediately. The TE/GE Division Employee Plans (EP) function is tasked with enforcing the Department of the Treasury's ERISA requirements, which include monitoring compliance with minimum funding requirements and assessing an excise tax on funding deficiencies.

The EP function monitors minimum funding requirements by using a Funding Deficiency Table, which is an inventory of all Form 5500 returns that report a funding deficiency over a certain dollar amount. Classifiers in the EP function perform research on the returns and attempt to contact plan sponsors to request an explanation and/or resolution of the funding deficiency. Funding deficiencies that remain after the EP classification research has been completed can be assigned to the EP Examination function to determine whether an excise tax should be assessed.

In summary, the EP function is not sufficiently ensuring Form 5500 returns with reported funding deficiencies are adequately resolved. Specifically, in October 2003, EP function management decided to close a significant number of older cases without working them because of other priorities. Several factors were considered in deciding to close these cases, but the primary reason was that, historically, a high percentage of returns on the Funding Deficiency Table are actually in compliance with minimum funding requirements; therefore, an examination would not be necessary. We also determined that EP function classifiers did not always take sufficient actions to resolve funding deficiencies or entered inaccurate and/or incomplete closing actions on the Funding Deficiency Table, so neither we nor EP function management could determine whether appropriate actions had been taken to resolve the funding deficiencies.

Regarding the closure of cases, the Funding Deficiency Table included 3,798 Form 5500 returns that were posted to the Internal Revenue Service (IRS) Master File³ in either Fiscal Year (FY)⁴ 2002 or 2003. Of the 3,798 returns, 842 (22 percent) were closed without being worked by the EP function. These plans reported underfunding of approximately \$672 million on the Forms 5500.

We also determined cases were not always worked in accordance with EP function procedures. One reason is that the Funding Deficiency Table was not designed as an inventory management and control system and has limitations for monitoring case assignments. We analyzed documentation for 1,650 Form 5500 returns that posted to the IRS Master File in FY 2002 and determined EP function classifiers had performed research to assess whether the plan sponsors resolved the potential deficiencies for

³ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

⁴ The IRS uses a processing fiscal year that starts with October 1 of the previous year and ends on September 30 of the current year. For example, FY 2002 started October 1, 2001, and ended September 30, 2002.

1,082 of these returns. However, for 225 of the 1,082 returns, insufficient follow-up actions were taken or cases were closed without a determination as to whether the funding deficiency existed and/or had been resolved.

In addition, our analysis of case actions for the 1,047 returns on the Funding Deficiency Table that were worked by EP function classifiers and posted to the Master File in FY 2002 found inaccurate and/or incomplete information. For example, 85 returns had incorrect closing codes recorded on the Funding Deficiency Table, and 82 returns had actions recorded in the comment section that were either unclear or did not fully address all the actions that should have been taken. Also, 440 returns did not have any information recorded in the comment section, which does not provide EP function management the necessary information to verify the correct closing codes were used.

We recommended the Director, EP, establish a process for prioritizing returns on the Funding Deficiency Table based on risk factors that will ensure returns with the greatest risk of insufficient funding for future retirement benefits are worked first. In addition, we recommended the Director, EP Examination function, perform the following: reemphasize the procedures for working returns with reported funding deficiencies; expand the classification funding procedures to include all the actions necessary to resolve potential funding deficiencies; improve the Funding Deficiency Table by creating closing codes to accommodate all closing actions; and establish a periodic managerial review process of the Funding Deficiency Table to ensure funding deficiency cases were adequately resolved and accurately recorded.

Management's Response: TE/GE Division Management agreed with the findings and recommendations in the report. Specifically, TE/GE Division management will establish criteria for prioritizing returns on the Funding Deficiency Table based on risk factors; reemphasize procedures for working returns with reported funding deficiencies; update the funding procedures manual to include action codes, no action code or letter result code for bankruptcies and unable to locate taxpayers; and implement a monitoring process of the funding deficiency program. TE/GE Division management stated they have also revised the funding procedures manual to expand the closing codes to better indicate the closing action recorded on the Funding Deficiency Table. In addition, the EP Classification function will periodically review the Funding Deficiency Table comment section for all cases closed due to taxpayer error and will work with a representative from the EP Customer Education and Outreach function once error trends are identified. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Background

Pension plans provide millions of Americans the opportunity to acquire income for retirement. The Employee Retirement Income Security Act (ERISA) of 1974¹ establishes the basic requirements for employee benefit plans. The sponsors² of pension plans and other fiduciaries have a responsibility to protect the interests of the workers and retirees who are covered by the benefit plans. The plan trustee or trustees are responsible for managing the assets in the pension plan to provide for future retirements. Generally speaking, there are two types of plans:

- Defined Benefit Pension Plans – benefits paid to participants at retirement are determined in advance by preestablished formulas. These types of plans are usually funded by employer contributions and have remained particularly popular in specific industries.
- Defined Contribution Retirement Plans – contributions to participants' retirement plan accounts are determined in advance. An example of this type of plan would be a tax deferred savings account in which a plan participant allocates a portion of his or her salaries or wages to investments within the plan. In some instances, employers may match all or a portion of the contribution.

Pension plans invest assets in different vehicles, such as the stock market or mutual funds, whose value may fluctuate depending on the volatility of the financial and economic markets. The ERISA Section 302 or Internal Revenue Code (I.R.C.) Section 412 establish the minimum annual funding amounts employers must contribute to plans in an effort to ensure plans have enough money to pay benefits when due. The ERISA allows for plans to be underfunded except when

¹ 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.).

² A plan sponsor for a single employer plan is an employer that establishes or maintains a pension plan for its employees. A plan sponsor for a multiemployer plan is the board of trustees that oversees a multiemployer pension plan. A multiemployer plan is a pension plan set up by collectively bargained agreements involving more than one unrelated employer, generally in one common industry (e.g., a plan set up between a union and two or more employers).

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the level of the fund drops below the minimum annual funding level. Pension underfunding has recently become a greater concern. An example of the impact of fluctuating markets on the value of the pension plans occurred in 2002 when 320 companies in the Standard and Poor's (S&P) 500 Index had defined benefit pension asset losses of \$106 billion.³ The Wilshire Associates study also reported that, for these 320 companies, the pension surplus (the difference between the market value of assets and liabilities) of \$34 billion at the end of 2001 dropped to a deficit of \$177 billion by the end of 2002. However, pension asset levels are only one factor used in determining whether pension plans are meeting the ERISA minimum funding requirements and, therefore, plan sponsors are generally not required to offset all pension asset losses with corresponding contributions to the plans. In 2002, plan sponsors responded by making contributions to their pension plans totaling \$41 billion.

Minimum funding requirements outlined in the I.R.C. and the ERISA are designed to ensure pension plans have sufficient assets to pay benefits when those benefits become due. However, these requirements may not be sufficient for pension plans that may need to be terminated because of sustained significant market drops. The Pension Benefit Guaranty Corporation (PBGC)⁴ monitors the adequacy of pension plan funding to determine if a plan may need to be terminated immediately. The Executive Director for the PBGC testified before the House Committee on Ways and Means on April 30, 2003, stating that, "With pension

³ *2003 Corporate Funding Survey on Pensions (FASB 87)*, issued May 14, 2003, by Wilshire Associates Incorporated. This study covered defined benefit plans sponsored by S&P 500 companies, based on a survey of 320 companies in the S&P 500 Index that maintain defined benefit plans.

⁴ The PBGC insures pension benefits for the defined benefit plans that pay insurance premiums to the PBGC. The PBGC has the authority to terminate a plan if it determines the pension plan cannot pay current benefits. If an insured defined benefit plan fails or is terminated, the PBGC takes over the pension plan and is responsible for paying current and future benefits to participants. However, this may result in benefit reductions for some participants.

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promises⁵ growing and plan funding levels at their lowest point in more than a decade, the dollar amount of pension under funding has skyrocketed.” The Executive Director further testified that the failure of several large companies with highly underfunded plans has caused the PBGC’s insurance program for single employer plans to drop from a surplus of \$7.7 billion at the end of Fiscal Year (FY) 2001 to a deficit of \$3.6 billion by the end of FY 2002. The PBGC states there was \$300 billion in pension underfunding for FY 2002, although these underfunded pension plans may have met the minimum funding requirements under the ERISA.

If the ERISA minimum funding requirements are not met, the underfunding is reported on the Annual Return/Report of Employee Benefit Plan (Form 5500). In addition, the I.R.C.⁶ has established the following requirements and penalties for plan sponsors who report a funding deficiency on the Form 5500 and do not meet their minimum funding requirements:

- Excise tax can be assessed if the funding requirement is not paid within 8½ months after the end of the plan year. For multi-employer plans, a 5 percent excise tax may be assessed and for single employer plans, a 10 percent excise tax may be assessed.
- An additional 100 percent excise tax can be assessed if plan sponsors do not correct the funding deficiency within the tax period in which the excise tax was assessed.

Under the ERISA, the Department of Labor (DOL) and the Department of the Treasury jointly have the authority to issue regulations and ensure the ERISA is enforced. The Presidential Reorganization Plan No. 4 of 1978 reduces the jurisdictional overlap of the ERISA by assigning the statutory authority for the minimum standards to the

⁵ These are agreements made between management and workers to increase pensions, sometimes in lieu of larger wage increases. The PBGC testified about a concern with financially troubled companies making pension promises that companies later find they are unable to keep.

⁶ I.R.C. § 4971 (2003).

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Department of the Treasury, which includes the employee plans funding requirements. The IRS Tax Exempt and Government Entities Division Employee Plans (EP) function is the organization tasked with enforcing the Department of the Treasury's ERISA requirements, which include monitoring compliance with minimum funding requirements and assessing an excise tax on funding deficiencies. The IRS considers a pension plan to have a funding deficiency if the level of the fund does not meet the ERISA minimum funding requirement when the Form 5500 is filed.

The EP function established the following process to monitor minimum funding requirements prescribed by the ERISA. A Funding Deficiency Table was created to maintain an inventory of all Form 5500 returns that report a funding deficiency over a certain dollar amount. The Form 5500 return information on the Return Inventory Classification System (RICS)⁷ is used to update the Funding Deficiency Table.

Classifiers in the EP function attempt to resolve the funding deficiencies by performing research on the inventory of returns and by attempting to contact plan sponsors to request an explanation and/or resolution of the funding deficiency. These resolutions can include:

- A return for which the plan sponsor paid the funding deficiency after the return due date but before the 8½ month deadline in the I.R.C. This type of payment is considered to be timely and is classified as a timing difference.
- A return on which the plan sponsor made an error in the preparation of the Form 5500, but the correct amount would not reflect a funding deficiency.
- An excise tax return filed reporting the correct amount of excise tax and the funding deficiency was subsequently paid after the due date.

⁷ The RICS is the inventory system used by the EP function to control, select, and monitor the results of examinations.

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In addition, if this contact does not sufficiently resolve the funding deficiency, the EP function classifier can assign the return to the appropriate EP Examination function field group. If a plan sponsor does not agree to pay excise taxes and minimum funding amounts, the EP function refers the unagreed case to the DOL.

The audit was conducted in accordance with *Government Auditing Standards* at the EP Planning and Programs office located in Baltimore, Maryland, during the period January through June 2004. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Establishing Priorities for Working Funding Deficiency Cases Would Ensure Returns With the Greatest Risk of Funding Problems Are Worked

The EP function is not sufficiently ensuring Form 5500 returns with reported funding deficiencies are adequately resolved. Specifically, in October 2003, EP function management decided to close a significant number of older cases without working them because of other priorities. We also determined that EP function classifiers did not always take sufficient actions to resolve funding deficiencies or entered inaccurate and/or incomplete closing actions on the Funding Deficiency Table.⁸ As a result, EP function management cannot be assured that plan sponsors are in compliance with the minimum funding requirements outlined in the ERISA.

The Funding Deficiency Table included 3,798 Form 5500 returns with reported funding deficiencies of over \$2 billion for Forms 5500 that were posted to the IRS Master File⁹ in either FY¹⁰ 2002 or 2003. Of the 3,798 returns, 842 (22 percent) were closed without being worked by the EP function. These plans reported underfunding of approximately \$672 million on the Forms 5500. In addition, we identified 66 returns that posted to the Master

⁸ This issue is presented in more detail later in the report.

⁹ The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

¹⁰ The IRS uses a processing fiscal year that starts with October 1 of the previous year and ends on September 30 of the current year. For example, FY 2002 started October 1, 2001, and ended September 30, 2002.

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File in FY 2002 that were still open on the Funding Deficiency Table as of January 2004; however, no work had been done to resolve the funding deficiency and there was less than a year before the assessment statute expired. These reported funding deficiencies totaled over \$14 million. EP function management advised us they were also considering closing these 66 returns without working them.

Several factors were considered by EP function management in deciding to close these cases:

- Historically, a high percentage of Form 5500 returns on the Funding Deficiency Table are actually in compliance with minimum funding requirements; therefore, an examination would not be necessary.
- The RICS, which is used to populate the Funding Deficiency Table, was shut down for 3 months to convert to a new operating system. This caused the EP Classification function to shift work priorities to meet the preconversion and postconversion inventory needs.
- All RICS databases were moved to a new computer server, which necessitated the development of new procedures before EP function classifiers could use the new database.

As a result, in October 2003, EP function management decided to realign its workload by closing returns from old tax periods (any plans with a fiscal year ending date before May 2001). The May 2001 date was selected because timely filed returns would have at least 1 year remaining on the Form 5500 return statute date. EP function management believes at least 1 year remaining on the Form 5500 return statute date is needed to perform an examination. However, a closer analysis of the 2,285 returns closed in October 2003 (for Form 5500 returns posting in FYs 1999 through 2003), showed the following:

- For 238 returns with funding deficiencies totaling \$91 million, there was still over 1 year remaining before the statute for the Form 5500 returns would expire (these were late-filed Form 5500 returns).

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- For 532 returns with funding deficiencies totaling \$537 million, there was less than 1 year remaining before the statute for the Form 5500 returns would expire.
- For 1,515 returns with funding deficiencies totaling \$591 million, the Form 5500 return statute date had already expired.

We found that the 238 returns had been filed late, so the statute expiration date for the Form 5500 return would be calculated from the late-filing date, not from the due date of the return. As a result, the EP function may have had more time to assess applicable excise taxes.¹¹ Using the tax period as the primary criterion for closing older returns on the Funding Deficiency Table may unnecessarily allow late-filed returns to be closed without being worked.

Funding deficiencies in multiple years could be an indicator that funding problems are persisting over extended periods and may increase the risk the plan will become insolvent and/or need to be terminated. We looked for additional plans that reported funding deficiencies in more than 1 year. Our analyses identified several plans on the Funding Deficiency Table with Form 5500 returns posting to the IRS Master File in more than 1 year during the period October 1, 1998, through September 30, 2003. For example, of the 3,798 FYs 2002 and 2003 returns on the Funding Deficiency Table, 349 plans that reported funding deficiencies in 1 of these 2 years also had another reported funding deficiency during the period FYs 1999 through 2003. These 349 plans accounted for 755 returns having a total reported funding deficiency of approximately \$1.5 billion.

Although EP function classifiers are advised to perform research to identify plans with multiple funding deficiencies, EP function management does not have an indicator for multiple years on the Funding Deficiency Table. Such an indicator would be helpful to EP function management in prioritizing returns on the Table.

¹¹ The excise tax statute assessment is 3 years from the date the excise tax return is filed, which could be different from the Form 5500 return filing date.

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To make better use of resources, EP function management should change its case assignment practices to prioritize returns so EP function classifiers research the highest risk cases. Prioritizing cases based on key factors such as the amount of dollars or the number of participants at risk, in addition to multiple years on the Funding Deficiency Table, would better assist the EP function in identifying plan sponsors that are at a higher risk of not being able to meet future retirement benefits. While it would be beneficial for all plan sponsors to be notified of the need to be in compliance with minimum funding requirements, the EP function should ensure the plans with the highest risk are contacted.

Because the IRS has not devoted sufficient resources to ensure all Form 5500 returns on the Funding Deficiency Table are resolved and has not developed a system to prioritize returns on the Funding Deficiency Table, plan sponsors with large funding deficiencies or with funding deficiencies in multiple periods may not have any actions taken to resolve their funding deficiencies. If funding deficiencies are not resolved and are allowed to continue, pension plans may be left at risk of not having sufficient assets to provide for future retirements.

Recommendation

1. The Director, EP, should establish a process for prioritizing returns on the Funding Deficiency Table based on risk factors that will ensure returns with the greatest risk of insufficient funding for future retirement benefits are worked first.

Management's Response: The Manager, EP Classification, will be assigned the responsibility to establish criteria for prioritizing returns on the Funding Deficiency Table based on risk factors (industry, economic conditions, participant/assets, multiple years of funding deficiencies) that will ensure returns with the greatest risk of insufficient funding for future retirement benefits are worked first.

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Enhanced Processes Are Necessary to Ensure Funding Deficiencies Are Sufficiently Researched and Accurately and Completely Documented

We identified several weaknesses in how cases were researched and resolved on the Funding Deficiency Table and how case actions were documented on the Table. Specifically, cases on the Table were not always worked in accordance with EP function procedures, and the Funding Deficiency Table contained inaccurate and/or incomplete information, so neither we nor EP function management could determine whether appropriate actions had been taken to resolve the funding deficiency. In addition, the Funding Deficiency Table was not designed as an inventory management and control system and has limitations for monitoring case assignments.

Returns with potential funding deficiencies were not sufficiently worked

We analyzed the documentation on the Funding Deficiency Table for 1,650 Form 5500 returns that posted to the IRS Master File in FY 2002 and determined EP function classifiers had performed research to assess whether the plan sponsor had resolved the potential deficiencies for 1,082 of these returns. In reviewing the limited documentation available on the Funding Deficiency Table for 225 of the research returns, we either determined the case actions were insufficient or could not determine if the funding deficiencies were appropriately resolved. These 225 returns included:

- Thirty-five returns for which insufficient follow-up actions were taken on the compliance letters sent to plan sponsors. In these instances, it had been over 1 year since the compliance letters had been sent, and, for 31 of the 35 cases, there was no further action documented on the Funding Deficiency Table. EP function management was unaware that follow-up actions had not been taken. As a result, EP function management does not know if the funding deficiencies were adequately resolved or if excise taxes were required to be filed and paid.
- Fifty-one returns for which cases were closed on the Funding Deficiency Table involving specialized funding laws without a determination as to whether the plan sponsors had complied with the appropriate funding procedures. These returns involved taxpayers from

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Puerto Rico, who have funding rules which are unique and different from those for other plans. The EP function did not have procedures in place to instruct classifiers to forward these cases to a group with specialized expertise on international issues.

- Nine returns referred by EP function classifiers to EP Examination function field groups; however, the returns were closed by the EP Examination function field groups without a validation as to whether the funding deficiency existed. If examination cases are closed without being worked, the EP function procedures require the EP Examination function field group to coordinate this action with the EP Classification function. The Manager, EP Classification, advised us that these closing actions were not coordinated between the EP Examination field group and EP Classification functions.
- One hundred sixteen returns for which EP function classifiers determined an excise tax return was filed as a result of a funding deficiency; however, no compliance letter had been sent to the plan sponsor to determine whether the funding deficiency had been resolved.
- Fourteen returns for which cases were closed without a determination as to whether the plan sponsor had resolved the funding deficiency involving bankrupt or “unable to locate” plan sponsors. EP function procedures do not address the actions that need to be taken to resolve these types of potential funding deficiencies and allow EP function classifiers to determine the necessary actions. This could result in inconsistencies in the amount of time and effort to resolve these returns.

EP function management recognized that Form 5500 returns on the Funding Deficiency Table were not being adequately resolved; they are in the process of developing new guidelines for processing these returns. One new process was started in June 2004 and requires classifiers to provide a monthly tracking chart to the Manager, EP Classification, which will assist the Manager in monitoring activities and assessing the status of returns on the Funding Deficiency Table. In addition, the Manager, EP Classification, had

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previously clarified procedures in February 2004 by instructing EP function classifiers to send a compliance letter requesting verification that the funding deficiency was paid when the EP function classifier determined that the plan sponsor had filed an excise tax return. Prior to this, some EP function classifiers were closing these types of returns from the Table without attempting to verify whether the funding deficiencies were paid. These procedures were brought to the EP function classifiers' attention during their monthly meetings.

Also, EP function management advised us that an automated letter generation enhancement on the RICS was piloted in October 2003. This enhancement will streamline the process of developing correspondence by allowing EP function classifiers to draft letters by inserting paragraphs previously prepared. In addition, an automated worksheet enhancement was being tested on the Funding Deficiency Table. The automated worksheet enhancement will allow EP function classifiers to readily review pertinent Form 5500 information by systemically inserting RICS data into the Funding Deficiency Table. EP function management believes these actions will improve the efficiency and consistency of case actions.

Further, the Manager, EP Classification, advised us that limitations to information on the Funding Deficiency Table prevented effective monitoring of classifiers' activities. For example, the Funding Deficiency Table does not indicate which cases are being worked until the contact letter is sent to the plan sponsor.

The Funding Deficiency Table contained inaccurate and/or incomplete information

The Funding Deficiency Table serves as the inventory management and control system for funding deficiency cases in the EP Classification function, but there are limitations for monitoring case assignments. Because of these shortcomings, EP function management relies heavily on EP function classifiers to accurately and completely record the status of case assignments and the actions taken to resolve the funding deficiencies.

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We determined the Funding Deficiency Table does not provide sufficient information for all types of closures. Specifically, the Table does not have closing codes or other identifiers for cases referred to the field for examination, requiring special expertise (such as the cases from Puerto Rico), or for which the classifier was unable to locate the plan sponsor.

As a result, the only way to identify these types of cases using the Funding Deficiency Table is to review the comment section. Another option for identifying the cases referred to the EP Examination function field groups is to run a special computer application comparing RICS data to information on the Funding Deficiency Table.

However, our analysis of case actions for the 1,047 returns on the Funding Deficiency Table that were worked by classifiers and posted to the Master File in FY 2002 found numerous examples of inaccurate and/or incomplete information.

- We identified 85 returns that had incorrect closing codes recorded on the Funding Deficiency Table, based on a comparison of the closing code and the comment section. For example, some returns were closed with a taxpayer error closing code, but the comment indicated the plan sponsor had filed an excise tax return and had also made up the funding deficiency.
- We identified 82 returns for which actions recorded in the comment section were either unclear compared to the letter results code that was entered by the EP function classifier or the comment section did not fully address all the actions that should have been taken to research the funding deficiency. For example, some returns were closed using the excise tax return closing code but were silent on whether the funding deficiency was paid.

Also, we identified 440 returns with no information recorded in the comment section. Without this documentation, EP function management cannot determine if the cases were properly worked and the correct closing codes used.

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Although the Funding Deficiency Table has limitations as stated above, it is the primary means to record case activity for funding deficiency cases and management uses it to review case activity. As a result, it is important for EP function management to emphasize documentation requirements to the EP classifiers.

In addition to providing management the ability to adequately review case activity, another benefit from an accurate and complete Funding Deficiency Table is the use by the EP Education and Outreach function to assist plan sponsors in correctly preparing funding deficiency schedules on the Form 5500. We analyzed the Funding Deficiency Table for the 745 returns that posted to the Master File in FY 2002 and for which the case was closed after a compliance letter was sent. For 487 (65 percent) of these cases, the EP function classifier learned the funding deficiency did not exist after receiving a response to the compliance letter that the plan sponsor had made an error in completing Form 5500. Additional education and outreach may reduce the number of these errors, which would reduce the number of returns on the Funding Deficiency Table. Further, EP function classifiers did not adequately describe the error in the Funding Deficiency Table for 399 of the 487 cases, which does not provide EP function management with the information needed to determine whether education and outreach is needed to prevent or reduce the errors.

Although EP function management stated the Funding Deficiency Table was never meant to be an inventory control system, it is considered the official record that documents the EP function classifiers' results of working funding deficiency cases. For EP function management to effectively manage this program, a management information system is needed which will enable management to prioritize and manage workload, evaluate trends, and identify specific education and outreach issues to benefit customers. If the Funding Deficiency Table is used for this purpose, it should be enhanced to include closing codes for all types of case closures and contain complete history information about case actions and how the funding deficiency was resolved. This would provide EP function management with the necessary information to ensure

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returns with reported funding deficiencies are appropriately resolved.

Recommendations

The Director, EP Examination, should:

2. Reemphasize the following procedures for working a Form 5500 return with a reported funding deficiency:
 - Before a funding deficiency case sent to an EP Examination function group is closed without an examination, the field examiners in the EP Examination function should coordinate this action with the EP Classification function.
 - EP function classifiers should use the correct closing code to indicate how the funding deficiency is resolved.
 - EP function classifiers should document in the “comment” section of the Funding Deficiency Table the reason for closing a return instead of sending it to the EP Examination function.

Management’s Response: The Director, EP Examination, will issue a field directive to reemphasize the procedures for working returns with reported funding deficiencies. The EP Classification function is expanding the funding procedures manual to better define the appropriate action code to be used when updating the Funding Deficiency Table and to require documentation, as appropriate, in the comment section when a return is not selected.

3. Expand the EP Classification function funding procedures to include all the actions necessary to resolve potential funding deficiencies including bankruptcies, unable to locate taxpayers, and examinations requiring the special expertise of international tax law.

Management’s Response: The EP Classification function will update the funding procedures manual to include action codes, no action code or letter result code, for bankruptcies and unable to locate taxpayers. Management will also include the research steps classifiers will take for those

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cases. All international cases assigned will be noted in the comment section of the Funding Deficiency Table.

4. Improve the Funding Deficiency Table by creating closing codes to accommodate all closing actions including examination referrals and unable to locate plan sponsors.

Management's Response: The EP Classification function has revised the funding procedures manual to expand the closing codes to better indicate the closing action recorded on the Funding Deficiency Table.

5. Establish a periodic managerial review process for the Funding Deficiency Table to ensure funding deficiency cases were adequately resolved and accurately recorded.

Management's Response: The EP Classification function is currently implementing a monitoring process for the deficiency program. A schedule will be developed to perform workload reviews to ensure funding deficiency cases are adequately resolved and accurately recorded.

6. Periodically review the funding deficiency cases that are closed because of a taxpayer error to determine whether any of the errors could be reduced or eliminated through additional education and outreach.

Management's Response: The EP Classification function will periodically review the comment section for all cases closed due to taxpayer error and will work with a representative from the EP Customer Education and Outreach function once error trends are identified.

Detailed Objective, Scope, and Methodology

The objective of this audit was to determine whether the processes the Tax Exempt and Government Entities Division uses ensure the funding deficiencies reported by defined benefit and defined contribution pension plans were appropriately resolved. To accomplish our objective, we:

- I. Determined whether the processes the Employee Plans (EP) function uses effectively ensured Annual Return/Report of Employee Benefit Plan (Form 5500) returns reporting potential minimum funding deficiencies were appropriately resolved.
 - A. Interviewed EP Examination function personnel and reviewed supporting documentation to determine the process the EP function uses to ensure the Return Inventory Classification System (RICS)¹ under the Funding Deficiency Table contains all of the defined benefit and contribution plans with a reported funding deficiency.
 - B. Interviewed EP function management and obtained documentation of procedures to determine the process the EP function uses to ensure all returns with reported funding deficiencies are resolved.
 - C. Obtained a download of the 5,860 funding deficiencies that posted to the Internal Revenue Service (IRS) Master File² during Fiscal Years 1999 through 2003 and categorized the records by 1) closed by compliance letter, 2) closed by examination, 3) closed without an examination or compliance letter, or 4) open/unresolved to determine whether the EP function appropriately resolved the funding deficiencies.
- II. Evaluated the results of compliance letter closures to determine whether process improvements can be identified to reduce the number of cases with taxpayer and/or IRS errors.
 - A. Determined whether the EP function has a process to evaluate the funding deficiencies resulting from errors and to either correct the IRS process or educate the plan sponsors to prevent the errors in the future.

¹ The RICS is the inventory system used by the EP function to control, select, and monitor the results of examinations.

² The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

James V. Westcott, Audit Manager

Michael R. Van Nevel, Lead Auditor

Andrew J. Burns, Auditor

**Establishing Case Priorities and Enhancing the Processes Would Improve the Employee
Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500**

Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner – Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Deputy Commissioner, Tax Exempt and Government Entities Division SE:T
Director, Employee Plans, Tax Exempt and Government Entities Division SE:T:EP
Director, Employee Plans Examinations, Tax Exempt and Government Entities Division
SE:T:EP:E
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Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
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Division SE:T:CL

Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to the Congress.

Type and Value of Outcome Measure:

- Reliability of Information – Potential; 167 Funding Deficiency Table records with inaccurate and/or incomplete information (see page 5).

Methodology Used to Measure the Reported Benefit:

The Employee Plans (EP) function established a Funding Deficiency Table to maintain an inventory of all Annual Return/Report of Employee Benefit Plan (Form 5500) returns that report a funding deficiency over a certain dollar amount. Classifiers in the EP function attempt to resolve the funding deficiencies by performing research on the inventory of returns and by attempting to contact plan sponsors to request an explanation and/or resolution of the funding deficiency. The Funding Deficiency Table serves as the inventory management and control system for funding deficiency cases in the EP Classification function.

Our analysis of case actions for 1,047 returns on the Funding Deficiency Table that posted to the Master File¹ in Fiscal Year 2002 and were worked by EP function classifiers found 167 returns with inaccurate and/or incomplete information. These included 85 returns with incorrect closing codes and 82 returns for which actions recorded in the comment section were unclear. An accurate and complete Funding Deficiency Table will provide management the ability to adequately review case activity. It will also enable the EP Education and Outreach function to assist plan sponsors in correctly preparing funding deficiency schedules on the Form 5500.

¹ The Internal Revenue Service database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Establishing Case Priorities and Enhancing the Processes Would Improve the Employee Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500

Appendix V

Management's Response to the Draft Report

RECEIVED

SEP 24 2004



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D. C. 20224

SEP 24 2004

MEMORANDUM FOR DANIEL R. DEVLIN ASSISTANT INSPECTOR GENERAL
FOR AUDIT (HEADQUARTERS OPERATIONS AND
EXEMPT ORGANIZATIONS PROGRAMS)

FROM: Steven T. Miller, Commissioner *STM/ Sarah Halloran*
Tax Exempt and Government Entities Division

SUBJECT: Management Response to Draft Audit Report –
Establishing Case Priorities and Enhancing the Processes
Would Improve the Employee Plans Efforts to Resolve
Reported Funding Deficiencies on Form 5500
(Audit # 200410010)

I have reviewed your draft report on ensuring that funding deficiencies reported by pension plans are appropriately resolved. Your examination of the procedures and data base records was exhaustive, and we appreciate the efforts that went into developing this report. Your recommendations can enhance our processes.

As you rightly point out, pension underfunding is an increasing concern. In addressing this issue, it is important that we focus our efforts on pension plans that are truly at risk, take early and effective steps to protect participants in those plans, and accurately track and measure our efforts.

Although a plan may note a funding deficiency when it files a Form 5500, Schedule B, our experience indicates that approximately 75 - 80% of such cases are resolved by the plan sponsor, without any action needed by the IRS. This results from the timing difference between the filing date of the return and the due date of the contribution to the plan, which is often later.

The TE/GE Division, Employee Plans (EP) function monitors minimum funding requirements under the Internal Revenue Code by operating a funding deficiency compliance check program and by posting inventory results and actions on what is called a Funding Deficiency Table.¹ Your report notes that under ERISA, the IRS shares responsibility with the Department of Labor (DOL) and the Pension Benefit Guaranty Corporation (PBGC) in the area of pension funding. EP's ability to resolve reported funding deficiencies is limited to assessing an excise tax on unresolved

¹ The Funding Deficiency Table is not the same thing as the risk list maintained by the Pension Benefit Guaranty Corporation.

Establishing Case Priorities and Enhancing the Processes Would Improve the Employee Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500

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funding deficiencies. However, as discussed below, I want to assure you that we are committed to improving our coordination on this issue with the DOL and PBGC.

EP's FY 2005 Workplan outlines a Pension Funding Initiative intended to better protect participants and the Treasury from chronic plan underfunding and plan failures. As part of this initiative, we will meet with the DOL and PBGC to determine if we can better facilitate early warning of funding problems and quicker coordinated enforcement responses. We will also review the schedule B to see if it is providing the information we need, and survey other data sources (including the PBGC and DOL databases) to determine if there is any information not currently shared that would help us in this area. The EP staff also is making changes in the procedures and operation of the program to implement the recommendations in the report. EP Examinations has assigned the resolution of funding deficiencies to the newly formed Employee Plans Compliance Unit (EPCU); this will facilitate the uniform processing of these cases. We also are implementing an automated compliance letter and worksheet program to increase the volume of letters and decrease the amount of time needed in operating the program.

I concur in your statement of the outcome measures identified in Appendix IV of your report.

Our responses to your specific recommendations are set forth below.

If you have any questions, your staff may contact either Rick Westley at (202) 283-9513 or Karl Zoric at (410) 962-9536.

RECOMMENDATION 1:

The Director, EP function, should establish a process for prioritizing returns on the Funding Deficiency Table based on risk factors that will ensure returns with the greatest risk of insufficient funding for future retirement benefits are worked first.

CORRECTIVE ACTION 1:

The Manager, EP Classification will be assigned the responsibility to establish criteria for prioritizing returns on the funding deficiency table based on risk factors (industry, economic conditions, participant/assets, multiple years of funding deficiencies) that will ensure returns with the greatest risk of insufficient funding for future retirement benefits, and those that pose the greatest risk to the PBGC, are worked first.

PROPOSED CORRECTIVE ACTION COMPLETION DATE:

January 15, 2005

RESPONSIBLE OFFICIAL:

Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this corrective item through the Business Performance Review (BPR) process and the Joint Audit Management Enterprise System (JAMES).

Establishing Case Priorities and Enhancing the Processes Would Improve the Employee Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500

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RECOMMENDATION 2:

Reemphasize the following procedures for working a Form 5500 return with a reported funding deficiency:

- Before a funding deficiency case sent to an EP Examination group is closed without an examination, the field examiners in the EP Examination function should coordinate this action with the EP Classification function.
- EP function classifiers should use the correct closing code to indicate how the funding deficiency is resolved.
- EP function classifiers should document in the "comment" section of the Funding Deficiency Table the reason for closing a return instead of sending it to the EP Examination function.

CORRECTIVE ACTION 2:

The Director of EP Examination will issue a field directive to reemphasize the procedures for working returns with reported funding deficiencies. EP Classification is expanding the funding procedures manual to better define the appropriate action code to be used when updating the Funding Deficiency Table and to require documentation, as appropriate, in the comment section when a return is not selected.

IMPLEMENTATION DATE:

November 15, 2004

RESPONSIBLE OFFICIAL:

Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this corrective item through the BPR and the James.

RECOMMENDATION 3:

Expand the EP Classification function funding procedures to include all the actions necessary to resolve potential funding deficiencies including bankruptcies, unable to locate taxpayer, and examinations requiring the special expertise of international tax law.

CORRECTIVE ACTION 3:

EP Classification will update the funding procedures manual to include action codes, no action code or letter result code, for bankruptcies and unable to locate taxpayer. The procedures will also be updated to include the research steps classifiers will take on bankruptcies and unable to locate taxpayers. All international cases assigned will be noted in the comment section of the funding deficiency table.

IMPLEMENTATION DATE:

January 15, 2005

RESPONSIBLE OFFICIAL:

Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this corrective item through the BPR and the JAMES.

Establishing Case Priorities and Enhancing the Processes Would Improve the Employee Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500

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RECOMMENDATION 4:

Improve the Funding Deficiency Table by creating closing codes to accommodate all closing actions including examinations, referrals, and unable to locate plan sponsors.

CORRECTIVE ACTION 4:

EP Classification has revised the funding procedures manual to expand the closing codes to better indicate the closing action that is recorded on the Funding Deficiency Table.

IMPLEMENTATION DATE:

Completed.

RESPONSIBLE OFFICIAL:

Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:

Completed.

RECOMMENDATION 5:

Establish a periodic managerial review process of the Funding Deficiency Table to ensure funding deficiency cases were adequately resolved and accurately recorded.

CORRECTIVE ACTION 5:

EP Classification is currently implementing a monitoring process for the deficiency program. A schedule will be developed to perform workload reviews to ensure funding deficiency cases are adequately resolved and accurately recorded.

IMPLEMENTATION DATE:

January 15, 2005

RESPONSIBLE OFFICIAL:

Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:

We will monitor this corrective item through the BPR and the JAMES.

RECOMMENDATION 6:

Periodically review the funding deficiency cases that are closed because of taxpayer error to determine whether any of the errors could be reduced or eliminated through additional education and outreach.

CORRECTIVE ACTION 6:

EP Classification will periodically review the comment section for all cases closed due to taxpayer error. Classification will work with a representative from CE & O once error trends are identified.

IMPLEMENTATION DATE:

Establishing Case Priorities and Enhancing the Processes Would Improve the Employee Plans Efforts to Resolve Reported Funding Deficiencies on Form 5500

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November 15, 2004

RESPONSIBLE OFFICIAL:
Director, EP Examinations

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this corrective item through the BPR and the JAMES.