

August 2000

# PENSION PLANS

## IRS Programs for Resolving Deviations From Tax-Exemption Requirements



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United States General Accounting Office  
Washington, D.C. 20548

General Government Division

B-282750

August 14, 2000

The Honorable Amo Houghton  
Chairman, Subcommittee on Oversight  
Committee on Ways and Means  
House of Representatives

Dear Mr. Chairman:

By extending tax-exempt status to qualified pension plans, the nation's tax laws have been used both to promote the establishment of employer-sponsored pension plans and to regulate those plans. Internal Revenue Service (IRS) records for the most recently available year indicated that in 1997, there were about 965,000 private, employer-sponsored, tax-qualified pension plans. These plans had about 127 million participants and had amassed assets totaling about \$3.6 trillion.

Maintaining these plans over time and protecting their assets are generally recognized as critical to the economic well-being of the U.S. workforce during retirement. Thus, for plans that might be at risk of losing their tax-exempt status because of deviations from tax code requirements, IRS has developed two programs to encourage plan sponsors to (1) detect and correct such deviations, (2) report those corrections to IRS for approval, and (3) pay a compliance fee as assessed by IRS.<sup>1</sup> Alternatively, if IRS finds the deviations in audits, it could revoke the plan's tax-exempt status—a severe penalty that may fall most heavily on those who are not responsible for the noncompliance, the covered employees.

As you requested, this report describes the extent of significant pension plan deviations from tax-exemption qualification requirements (hereafter referred to as qualification failures) and the incentives established for plan sponsors to report such failures to IRS.<sup>2</sup> Specifically, the objectives of this review were to

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<sup>1</sup>In general, plan sponsors that detect and correct insignificant deviations or quickly correct significant deviations (i.e., within specified correction periods) may do so without reporting the corrections to IRS for approval and without paying a compliance fee provided the correction does not involve amending plan documents.

<sup>2</sup>The term significant refers to qualification failures that, under IRS procedures, are determined to be serious enough to threaten a plan's tax-exempt status and thus constitute a defect warranting IRS supervision of the correction and assessment of a monetary sanction through an agreement negotiated

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- identify the frequency and types of pension plan qualification failures detected and corrected through IRS audits and those identified by pension plan sponsors and reported to IRS for approval of the correction;
  - compare the sanctions established under IRS' audit program with the compliance fees that could have been imposed if the same qualification failures had been self-reported by the pension plans to IRS; and
  - determine whether any cost-effective means, other than pension plan audits, have been identified that would detect unreported qualification failures.

As agreed with the Committee, we analyzed the frequency and types of qualification failures by plan size and plan type, such as defined benefit or defined contribution plans.<sup>3</sup>

To carry out this work, we reviewed the qualification failure cases closed by IRS in fiscal year 1999 covering 1,802 pension plans. These cases resulted from IRS audits of plans and the two pension plan self-reporting programs established by IRS, the Walk-In Closing Agreement Program (referred to in this report as the Walk-In Program) and the Voluntary Compliance Resolution (VCR) Program. Also, for a random sample of the audit cases, we determined the range of compliance fees that the plan sponsors could have paid if the plan sponsor had corrected the failures and reported them to IRS for approval. We did our work between May 1999 and May 2000 in accordance with generally accepted government auditing standards.<sup>4</sup>

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## Results in Brief

Our review of all IRS fiscal year 1999 qualification failure case closings showed that of the 1,802 affected pension plans,

- 42 percent experienced plan document failures (i.e., the documents governing plan operations did not comply with tax law requirements);
- 66 percent experienced at least one operational failure (i.e., the plan did not operate in accord with plan documents);

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to conclude an IRS audit or assessment of a compliance fee through IRS' pension plan self-reporting programs.

<sup>3</sup>In general, a defined benefit plan is one that specifies the benefits or the method of determining benefits payable by the plan, such as the percentage of employee compensation payable to an employee upon qualifying for retirement under the terms of the plan. A defined contribution plan is one that specifies the contributions that are to be made to the plan. The benefit payable on retirement would be dependent on the amounts of contributions made and the earnings on those contributions.

<sup>4</sup>See appendix I for a more detailed description of the assignment's scope and methodology, including a description of the work done to discuss alternatives to audit with IRS National Office officials and representatives of organizations involved in pension law, accounting, and pension operations.

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- less than 2 percent experienced demographic failures (i.e., the plans had failed certain tests for ensuring that pension benefits were provided in a nondiscriminatory manner);
  - 9 percent had both operational and document failures; and
  - in general, all types and sizes of plans were represented among those with qualification failures.

Our review of a random sample of fiscal year 1999 closed audit cases showed that, on average, pension plan sponsors were assessed monetary sanctions that we estimated were 10 times<sup>5</sup> greater than the compliance fees that could have been assessed if the plan sponsors had reported the qualification failures to IRS for supervised correction. However, there were substantial differences in this ratio, depending on the type of reporting program available to the plans and the manner in which IRS applied its guidelines for assessing audit sanctions. IRS officials said that, because of concerns expressed by pension groups, they had initiatives under way (e.g., establishing new positions for reviewing qualification failure settlements) to ensure consistency among amounts assessed within compliance programs and coordination across compliance programs.

The pension experts we talked with at IRS and outside of the government generally viewed audits as an integral part of the government's efforts to promote voluntary compliance and preserve pension benefits for the U.S. workforce. While they did not identify any cost-effective alternatives to replace IRS audits, both IRS and the pension experts thought that enhancements could be made to existing IRS programs.

In commenting on a draft of this report, the Commissioner of Internal Revenue generally agreed that the report fairly and accurately described the correction of qualification failures covered by the scope of our review (i.e., the correction of deviations from qualification requirements that warranted IRS involvement).

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## Background

To qualify for tax-exempt status, pension plans must comply with an array of legal requirements specified in the Internal Revenue Code.<sup>6</sup> For example, plan sponsors are required to establish and maintain an updated, legally compliant, written pension plan document that is communicated to

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<sup>5</sup>95-percent confidence interval: 4 to 15 times.

<sup>6</sup>Section 401(a) addresses qualification requirements for pension, profit-sharing, and stock bonus plans. We use the term "pension plan" in this report to refer to all types of retirement plans that are subject to 401(a). Section 403 addresses requirements for annuity plans; however, we limited the scope of our review to section 401(a) pension plans and IRS programs that deal with these types of plans.

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employees and describes the specific terms and benefits provided under the plan.<sup>7</sup> Failure to maintain compliance with qualification requirements may ultimately lead to revocation of a plan's qualified status, including the loss of tax benefits,<sup>8</sup> which could potentially harm innocent pension plan participants.

No data exist on the qualification failure rate among the total population of defined benefit and defined contribution plans. However, IRS has completed some research into pension plan compliance issues that provided some data for certain plan types. From these data, which IRS developed by auditing random samples of 3 relatively common types of defined contribution plans, we estimated that less than 2 percent of the 529,000 plans<sup>9</sup> represented by the samples had experienced qualification failures in the mid-1990s (see app. II). Our estimate is based on audit closing codes that show the audit identified deviations from tax-exemption requirements that IRS considered significant enough to warrant obtaining a written agreement with the plans for correcting the failures and paying a monetary sanction.

The research data, however, were not sufficient to provide insights into the prevalence of qualification failures among the total population of pension plans nor to provide insights into the various types of failures experienced by the covered plans.

To enhance compliance with pension law requirements and help plan sponsors avoid revocation of their plans' tax-exempt status, IRS administratively introduced several compliance initiatives during the 1990s. Two of the initiatives, the VCR and Walk-In Programs, depend on pension plans to self-report qualification failures to IRS.<sup>10</sup> A third initiative involved IRS modifying its audit procedures to provide a standardized means for reaching agreements with pension plans to correct qualification

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<sup>7</sup>Treasury Regulation section 1.401-1(a)(2).

<sup>8</sup>The tax benefits of maintaining a qualified plan are the (1) tax deductibility of the employer's contributions to the plan, (2) deferred taxation for the participants on the contributions made by the employer on their behalf, and (3) deferred taxation on the participants' earnings accrued in the related exempt trust. See sections 402, 404, and 501(a), respectively.

<sup>9</sup>95-percent confidence interval: 1.1 to 2.3 percent. This confidence interval was computed to include the cases with unknown qualification failure status, as shown in table II.1.

<sup>10</sup>In addition, under the procedure establishing the pension plan self-reporting programs, plan sponsors that detect and correct insignificant deviations or quickly correct significant deviations (i.e., within specified correction periods) may do so without reporting the corrections to IRS for approval and without paying a compliance fee provided that the correction does not involve amending plan documents.

failures identified during audits of plan operations, thus avoiding revocation of tax-exempt status.

IRS distinguishes among three principal types of plan qualification failures:

- A document failure occurs when a written plan provision, or its absence, violates the provisions of the law related to maintaining a qualified pension plan;
- An operational failure occurs when a plan sponsor fails to follow provisions of the plan document in operating the plan; and
- A demographic failure occurs when a plan sponsor does not comply with specific provisions of pension law<sup>11</sup> intended to ensure that a plan does not discriminate in providing benefits and offering participation to employees.

Table 1 summarizes the types of qualification failures covered by the compliance programs, the correction methods authorized, and the nature of the compliance fee.

**Table 1: IRS' Pension Plan Compliance Programs for Supervising the Correction of Qualification Failures**

Program	Purpose	Eligible qualification failure	Authorized correction	Compliance fee or sanction
<b>VCR</b>	Allow plan sponsor to self-report selected qualification failures	Operational <sup>a</sup>	<ul style="list-style-type: none"> <li>•Correction limited to conforming plan operations to plan document provisions, plan amendments not permitted</li> <li>•Written document specifying the corrective action must be approved by IRS<sup>b</sup></li> </ul>	Published fee schedule based on plan asset amount and number of plan participants
<b>Walk-in</b>	Allow plan sponsor to self-report any qualification failures	Operational, document, demographic	<ul style="list-style-type: none"> <li>•Correction by conforming plan operations to plan document provisions and/or amending plan documents</li> <li>•Written document specifying the corrective action must be approved by IRS</li> </ul>	Fee negotiated with IRS, using graduated fee ranges based on number of plan participants with the lowest amount set equal to the VCR fee
<b>Audit</b>	Allow plan sponsor to correct failures IRS identifies during audits, i.e., examinations of plans' operational adherence to plan documents and plan document conformance to legal requirements	Operational, document, demographic	<ul style="list-style-type: none"> <li>•Correction by conforming plan operations to plan document provisions and/or amending plan documents</li> <li>•Written document specifying the corrective action must be approved by IRS</li> </ul>	Fee negotiated with IRS, based on nature, extent, and severity of failures

<sup>a</sup>VCR is not available for egregious operational failures, such as consistent and repeated failure to follow terms of the plan document.

<sup>b</sup>Under the VCR Program, a limited number of operational failures may be corrected using the Standardized VCR Procedure (SVP). For SVP qualified cases, a comparatively small compliance fee

<sup>11</sup>A demographic failure is a violation of either Internal Revenue Code section 401(a)(4), 401(a)(26), or 410(b) that is not an operational failure.

(i.e., \$350) is available—regardless of number of participants or trust asset amount—to plan sponsors who agree to use correction methods specified in IRS published guidance.

Source: GAO review of IRS procedures.

## 1,802 Agreements to Correct Qualification Failures Approved in 1999

As shown in table 2, 1,802 pension plans (about 0.2 percent of all types and sizes of plans) had agreements for correcting qualification failures approved by IRS in fiscal year 1999. About 80 percent of the plans self-identified the failures and used IRS' reporting programs to obtain approval for the corrections. The remainder entered into agreements to correct their failures as a result of an IRS audit.

**Table 2: Pension Plans With IRS-Approved Agreements for Correcting Qualification Failures in Fiscal Year 1999**

Plan size and type	Plans with qualification failure correction agreements			Total	Population of plans having filed recent annual reports with IRS	Percent of plans with correction agreements
	IRS audit	Walk-In Program	VCR Program			
<b>Plan size (number of participants)</b>						
Less than 10	192	339	108	639	568,953	0.11
11 to 50	77	132	196	405	213,579	0.19
51 to 100	28	51	83	162	53,522	0.30
101 to 300	43	57	130	230	41,859	0.55
301 to 1,000	13	38	98	149	18,591	0.80
1,001 to 10,000	11	13	126	150	10,451	1.44
More than 10,000	2	1	37	40	1,449	2.76
Missing data	0	23	4	27	56,565	0.05
<b>Total</b>	<b>366</b>	<b>654</b>	<b>782</b>	<b>1,802</b>	<b>964,969</b>	<b>0.19</b>
<b>Plan type</b>						
Defined Benefit	42	125	102	269	77,797	0.35
Defined Contribution						
Profit Sharing	228	347	577	1,152	619,797	0.19
Money Purchase	84	102	62	248	179,633	0.14
Stock Bonus <sup>a</sup>	5	21	20	46	4,473	1.03
Other	6	23	13	42	5,619	0.75
Subtotal	323	493	672	1,488	809,522	0.18
Missing data or unknown	1	36	8	45	77,650	0.06
<b>Total</b>	<b>366</b>	<b>654</b>	<b>782</b>	<b>1,802</b>	<b>964,969</b>	<b>0.19</b>

Note: Data on the total population of plans are based on IRS records of Form 5500 series annual reports filed by pension plans for 1997, the most recent year available.

<sup>a</sup>A stock bonus plan is established and maintained by an employer to provide employees or their beneficiaries with benefits that are distributable in stock of the employer.

Source: GAO review of IRS' qualification failure closing agreements and IRS' employee plans database as of May 2000.

Our review of the fiscal year 1999 agreements between IRS and the 1,802 pension plans for correcting the qualification failures showed the following:

- 42 percent of the plans experienced plan document failures (i.e., plan documents did not comply with tax law requirements). Most of these plans (559 of the 762 plans) had not been amended to reflect changes in pension law but were not otherwise determined to be noncompliant. The remainder had some combination of document, operational, and demographic problems, no single aspect of which predominated;
- 66 percent of the plans experienced at least one operational failure (i.e., the plan did not operate in accord with plan documents) and generally averaged an estimated two failures.<sup>12</sup> The operational failures cut across all categories of pension requirements, such as those covering employee participation in pension plans and employee vesting in employer-funded contributions and benefits. Some failures occurred more frequently than others, but no single type was experienced by a majority of pension plans;
- Less than 2 percent of the plans experienced demographic failures (i.e., the plans had failed certain tests for ensuring that pension benefits were provided in a nondiscriminatory manner); and
- 9 percent had both operational and document failures.

In general, all types and sizes of pension plans experienced qualification failures. Appendix III contains a technical description of these qualification failures. The appendix provides a detailed listing of the document, operational, and demographic failures referenced to the tax code section violated; the type and size of the plans that committed the failures; and whether the failures were identified in an IRS audit or self-reported by the plans.

## Audit Sanctions Generally Exceeded Compliance Fees That Could Have Been Assessed

Regarding IRS' use of sanctions and compliance fees as an incentive for plans to identify and report qualification failures to IRS for supervised correction, our analyses of a random sample of IRS fiscal year 1999 audit cases showed that, on average, plan sponsors were assessed audit sanctions that we estimate were between 4 and 15 times more per plan participant than could have been assessed had the failures been reported to IRS.<sup>13</sup>

<sup>12</sup>95-percent confidence interval: 2.1 to 2.3 failures.

<sup>13</sup>We made our comparison based on the cost per plan participant, rather than cost per plan, in order to standardize the comparison among plans. For example, a \$3,000 audit penalty may have greater significance to a small plan having 3 participants (i.e., a cost of \$1,000 per participant) than to a large plan having 3,000 participants (i.e., a cost of \$1 per participant).

Several factors contributed to the variation in the audit sanction-to-compliance fee ratio. In part, the type of self-reporting program available to the plans affected the ratio. Our analyses showed the following results:

- Plans that were eligible to use the VCR Program<sup>14</sup> could have avoided audit sanctions that we estimate were about 13 times<sup>15</sup> greater than the applicable VCR fee.
- Plans that were eligible to use the Walk-In Program<sup>16</sup> could have avoided audit sanctions that we estimate were about 30 percent<sup>17</sup> greater than the applicable Walk-In fees.

In general, as shown in table 3, the fee schedule of the VCR Program provided for assessing lower fees than the range of Walk-In fees. And, within plan size categories, the Walk-In Program fee schedule provided for higher fees for correcting more serious violations.

**Table 3: IRS Qualification Failure Sanction Guidelines**

Number of participants	VCR fee for plan with assets <sup>a</sup>		Walk-In fee range <sup>b</sup>	Audit sanction
	Less than \$500,000	\$500,000 or more		
10 or fewer	\$500	\$1,250	VCR fee – \$4,000	The sanction is to be a negotiated percentage of the Maximum Payment Amount. <sup>c</sup> The sanction is not to be excessive and is to bear a reasonable relationship to the nature, extent, and severity of the failures.
11–50	500	1,250	VCR fee – \$8,000	
51–100	500	1,250	VCR fee –\$12,000	
101–300	500	1,250	VCR fee –\$16,000	
301–1,000	500	1,250	VCR fee –\$30,000	
1,001–9,999	5,000	5,000	VCR fee –\$70,000	
10,000 or more	10,000	10,000	VCR fee –\$70,000	

<sup>a</sup>For plans eligible to use the SVP component of the VCR Program, the fee would be \$350 regardless of plan size. A total of 234 of the 1,802 plans with IRS-approved agreements to correct qualification failures in fiscal year 1999 qualified for SVP.

<sup>b</sup>The Walk-In fee ranges from a minimum amount equal to the VCR fee to the specified maximum. The mid-point of this range is the approximate starting point for the penalty assessment. More serious violations are to be assessed more and less serious violations less.

<sup>c</sup>Maximum Payment Amount is the approximation of the total tax that IRS could collect upon plan disqualification.

Source: IRS Revenue Procedure 98-22.

<sup>14</sup>A reporting program designed to correct certain operational qualification failures.

<sup>15</sup>95-percent confidence interval: 9.9 to 16.1 times.

<sup>16</sup>A reporting program designed to correct document, operational, and demographic qualification failures. Unlike the VCR Program, the Walk-In Program authorizes failures to be corrected through plan amendment.

<sup>17</sup>95-percent confidence interval: 20 to 40 percent.

In addition, the fee structure within both programs set much higher fees for small plans than large plans when compared on a per-plan-participant basis (see table 4). For example, the sponsor of the smallest plan (a one-participant plan) could be subject to a Walk-In compliance fee as large as \$4,000 per participant, while the sponsor of a plan with 10,000 participants would, at maximum, face a per-participant fee of \$7.

**Table 4: Minimum and Maximum Compliance Fees for Self-Reporting Plans**

Number of participants	Per-participant fee	
	Minimum <sup>e</sup>	Maximum
1–10	\$50.00	\$4,000.00
11–50	10.00	727.27
51–100	5.00	235.29
101–300	1.67	158.42
301–1,000	0.50	99.67
1,001–9,999	0.50	69.93
10,000 or more	<sup>t</sup>	7.00

<sup>a</sup> Excludes the SVP portion of the VCR Program, which is limited to certain operational failures. Because the fee is \$350 regardless of plan size, qualifying plans could see minimum per participant fees ranging from about \$35.00 for the smallest plans to less than \$0.04 for the largest plans.

<sup>b</sup> Less than \$1, depending on size of the plan.

Source: GAO analyses of IRS compliance fee guidelines.

Our analysis of the fiscal year 1999 audit cases showed that sponsors of plans with qualification failures that must be corrected by amending plan documents (e.g., those eligible for the Walk-In, but not the VCR, Program) would likely have been assessed fees that were greater than the fees for the VCR eligible plans—an estimated average of about \$1,167 per participant<sup>18</sup> compared with about \$68 per participant.<sup>19</sup>

The amount of the audit sanction is another factor that affects the sanction-to-compliance fee ratio. IRS’ guidelines for setting audit sanctions specify that they should be reasonable and the product of negotiations with the plan sponsors. Our analyses of the sample data showed that in applying the guidelines, IRS assessed audit sanctions in four cases that were less than the lowest applicable reporting program compliance fee and in four instances more than 50 times the lowest applicable compliance fee.

Determining the causes for the variations in the audit sanction-to-compliance fee ratios was outside the scope of our review. However, IRS

<sup>18</sup>95-percent confidence interval: \$1,021 to \$1,313.

<sup>19</sup>95-percent confidence interval: \$42 to \$94.

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National Office officials said that, given concerns previously expressed by pension groups, several initiatives were already under way to ensure consistency among amounts within the compliance programs and coordination of the amounts across programs. For example, in each office responsible for settling qualification failures, IRS is establishing new positions responsible for reviewing qualification failure settlements to ensure consistency within and coordination across compliance programs.<sup>20</sup>

The National Office officials also said that, in general, audit sanctions should be higher than the self-correction compliance fees and that the compliance fees for correcting qualification failures through plan amendment should be higher than the fees for correcting failures that do not involve amending plan documents. The higher audit sanctions were seen as a part of an incentive system promoting self-correction. Higher compliance fees were set for plan amendments because IRS views the plan documents as sacrosanct. As required by pension law, the documents set out the employers' commitments. And, in turn, employees depend on the employers meeting those pension commitments.

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## Experts View Audits as an Integral Part of IRS' Compliance Program

According to IRS, the primary objective of its pension plan examination program is regulatory, focusing on the continued tax qualification of the examined plans. Under IRS policy, the plans are to be audited to determine whether the plans' operations meet the applicable qualification requirements (i.e., plans operate in accord with plan documents, and plan documents conform to legal requirements). In fiscal year 1999, IRS audited about 14,000 returns filed by pension plans.

IRS pension audits were generally viewed by IRS and the pension experts we talked with, as an integral part of the government's efforts to promote voluntary compliance and to preserve pension benefits for the U.S. workforce. (App. I lists the pension practitioners, organizations representing the views of plan sponsors and participants, and other experts contacted.) For example, pension practitioners advised us that, given the complexity of pension law, it is relatively easy for a business sponsor of a plan to inadvertently do something that would constitute a qualification failure. Once the practitioner advising the plan is aware of

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<sup>20</sup>As part of the IRS-wide reorganization mandated by the IRS Restructuring and Reform Act of 1998 (P.L. 105-206), IRS established a new functional unit to administer pension tax law. The new organization, managed by the Director, Employee Plans, was established with three operational components: Employee Plans Customer Education and Outreach; Employee Plans Rulings and Agreements; and Employee Plans Examination. This part of the reorganization became effective in December 1999.

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such an apparent failure, the practitioner is responsible for providing the plan sponsor with advice on correcting the failure.

According to the practitioners, such advice would include identifying (1) possible corrective action options and the associated cost of making such corrections, (2) fees charged by IRS for approving the correction of such failures, and (3) audit sanctions that could be assessed by IRS if the plan sponsor did not submit the correction to IRS for approval or if the sponsor did not make the appropriate correction. Pension sponsors would then make a business decision on how to proceed (e.g., type and timing of the correction) based on available funds, correction costs, compliance fees, and the risk of audit and audit sanctions.

While neither IRS nor the pension experts that we spoke with identified cost-effective alternatives to replace IRS audits, they indicated that enhancements could be made to the existing compliance system. IRS tended to focus on reducing the burden on compliant plans, for example, by improving the audit selection process. In general, the pension experts identified changes that IRS could make that would promote voluntary compliance, thus reducing the need for audits or oversight of qualification failure correction. These included publishing information to help plans comply with pension requirements (e.g., a self-audit guide and the results of IRS compliance studies) and extending the provision for unsupervised and unpenalized correction of deviations from pension requirements to include allowing plan amendments under certain conditions.

Some pension experts differed on the appropriate role of IRS in supervising the correction of qualification failures that, under existing procedures, warrant reporting to IRS. Currently, plan sponsors may correct a failure, but if they do not report it to IRS and receive approval of the correction, they may be liable for a penalty if, during a subsequent audit, IRS detects the failure that already had been retroactively corrected by the plan sponsor. Some experts thought that if a plan sponsor corrected a failure and did not see a need for the certainty of an IRS opinion approving the correction, then the plan should only be penalized if the correction was subsequently determined by IRS to be inappropriate. Another expert indicated that his clients liked the certainty of closure that the existing self-reporting programs offered.

In discussing possible program changes with us, IRS officials said that their compliance programs are not a static system. Since 1992, when a self-reporting program was first introduced, IRS has made several significant changes. Moreover, IRS officials expect their compliance programs to be

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further revised as IRS gains experience and input from the pension community. They said that they are taking the views expressed by plan sponsors and practitioners, such as those discussed above, into consideration as they consider enhancements to their programs. They also pointed out that in the IRS reorganization currently under way, a new office of employee plan outreach has been established. This group is tasked with getting better information out to pension plans.

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## Agency Comments

In commenting on a draft of this report, the Commissioner of Internal Revenue generally agreed that the report fairly and accurately described the correction of qualification failures covered by the scope of our review (i.e., the correction of deviations from qualification requirements that warranted IRS involvement). The Commissioner also emphasized that, as we indicated in footnote 1, plan sponsors that detect and correct insignificant deviations from qualification requirements or quickly correct certain types of significant deviations may do so without IRS involvement. During our review, data were not available from IRS to estimate how frequently plan sponsors took such actions. Thus, this report does not contain data on the extent to which plan sponsors have corrected insignificant deviations from qualification requirements or quickly corrected certain types of significant deviations. In his comments, the Commissioner also described some additional organizational changes being made to promote consistency and coordination among IRS compliance actions. The full text of the Commissioner's comments is reprinted in appendix IV.

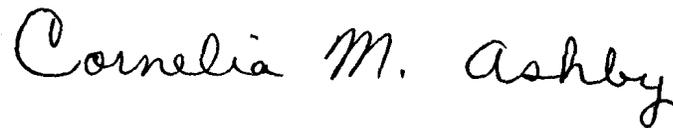
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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from the date of this letter. At that time, we will send copies to Representative William J. Coyne, Ranking Minority Member, Subcommittee on Oversight, House Committee on Ways and Means; the Honorable Charles O. Rossotti, Commissioner of Internal Revenue; other interested congressional committees; and other interested parties. We will also make copies available on request.

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Key contributors to this report are acknowledged in appendix V. If you have any questions, you may contact me or Thomas Richards on (202) 512-9110.

Sincerely yours,

A handwritten signature in black ink that reads "Cornelia M. Ashby". The signature is written in a cursive style with a large initial 'C' and a long, sweeping tail on the 'y'.

Cornelia M. Ashby  
Associate Director, Tax Policy  
and Administration Issues

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**Abbreviations**

IRS	Internal Revenue Service
SVP	Standardized VCR Procedure
VCR	Voluntary Compliance Resolution

# Objectives, Scope, and Methodology

## Objectives, Scope, and Methodology

Our objectives were to (1) identify the frequency and types of pension plan qualification failures detected and corrected through IRS audits and those identified by pension plan sponsors and reported to IRS for approval of the correction; (2) compare the sanctions established under IRS' audit program with the compliance fees that could have been imposed if the same qualification failures had been self-reported by the pension plans to IRS; and (3) determine whether any cost-effective means, other than pension plan audits, have been identified to detect unreported qualification failures.

As agreed with the Committee, we analyzed the frequency and types of qualification failures by plan size and plan type, such as defined benefit or defined contribution plans.

## Frequency and Type of Qualification Failures

To identify the frequency and types of pension plan qualification failures detected and corrected through IRS audits and those that pension plans self-reported to IRS for approval of the correction, we did the following:

- Reviewed available IRS research data on pension plan compliance with tax-exemption requirements and used these data to estimate the prevalence of pension plan deviations from tax-exemption requirements that would warrant being reported to IRS as qualification failures under the Voluntary Compliance Resolution (VCR) or Walk-In Programs;
- Visited the four IRS district offices responsible for coordinating the audit and Walk-In programs<sup>1</sup> to identify all cases closed under these programs during fiscal year 1999;<sup>2</sup>
- Identified all 366 audit cases and all 654 Walk-In cases with IRS approved agreements with pension plans for correcting qualification failures. We obtained the closing agreement for each case to determine the specific nature of the qualification failures identified. We collected data on the type of qualified plan and the number of plan participants from the form 5500 (the annual report filed by the pension plan) in the case file. If a form 5500 was not available from the case file, we obtained data on the type of plan and the number of participants from databases in the IRS district offices or National Office;

<sup>1</sup>During fiscal year 1999, IRS administered the audit and Walk-In programs through its four key district offices. IRS also closed a small number of qualification failure cases through agreements done in conjunction with the determination letter process. Those agreements were outside the scope of this review.

<sup>2</sup>We defined a "case" as being the equivalent of the results of an audit of one pension plan per employer. In situations where district offices combined the audit results for multiple pension plans of a single employer into one closing agreement, we considered each plan as a separate case.

- Collected similar data for all 782 VCR cases from files located in IRS national headquarters. Of the 782 total cases, 234 qualified for the Standardized VCR Procedure (SVP). We also obtained an IRS database that contained, among other data items, some limited information on the type of qualification failures found in VCR cases;
- Developed a classification methodology for cataloging the issues found in the audit, Walk-In, and VCR cases. We did this by reviewing pension law and regulations, by reviewing existing IRS classification issue methodologies, and by reviewing the language in the agreements closing these cases. We provided IRS pension program officials with a copy of our classification methodology for review and comment;
- Classified the issues found in all the audit and Walk-In cases that we identified as being closed in fiscal year 1999. Our classification of the qualification failures in each case relied on the description of each failure found in the closing agreement for the case. When the description of the failure included an explicit tax code citation, we classified the failure according to that citation. If specific code sections were not cited, we used our judgment in assigning failures to specific categories based on the language contained in the agreement; and
- Classified the issues found in VCR cases closed in fiscal year 1999. For VCR cases that did not qualify for SVP, we classified a random sample of 310 of 548 total cases. For these cases, our classification methodology was the same as for the audit and Walk-In cases. We then weighted the results from the random sample to obtain an estimate of the types of qualification failures reported in the 548 cases. For cases that qualified for SVP, we relied on issue classifications found in the IRS database of all VCR cases. This database contained issue codes for the limited types of failures that qualify under SVP.<sup>3</sup> The estimates of the types of qualification failures shown in the tables in appendix II for the VCR program as a whole combine the results from the classification of the random sample of cases, weighted to represent the population of all non-SVP cases, with the classifications for all SVP cases.

From the above, we calculated statistics on the types of qualification failures found in the cases by IRS program, plan size, and plan type. We did not review the quality of the audit, Walk-In, or VCR casework done by IRS. Nor did we make a reliability assessment of the IRS research data sets.

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<sup>3</sup>Before using the database, we tested the accuracy of a random sample of entries by tracing the cases back to source documents.

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## Comparison of Sanctions for Failures Detected Through Audit and Self-Reported by the Plans

To compare the sanctions assessed by IRS for qualification failures detected through audit with the compliance fees that could have been assessed if the same qualification failures had been self-reported by the pension plans to IRS for approval of correction, we did the following:

- Reviewed IRS policies and procedures for resolving pension plan qualification failures identified through IRS' audit, Walk-In, and VCR programs as well as the guidance on determining the monetary sanctions associated with each of these programs. We also discussed key district office procedures for administering both the audit and Walk-In programs and discussed qualification issues with each of the four key district office's closing agreement coordinators as well as officials from IRS who administered the VCR Program;
- Reviewed the 366 audit cases closed during fiscal year 1999 by the four key district offices to determine the specific nature of the qualification failures and the amount of the sanction imposed by IRS on the plan as a result of the audit;
- Organized the 366 cases into groupings that would enable us to sample the cases in a manner that ensured representative coverage by location and general type of the failure. First, we divided the 366 cases into 4 groups, depending on which of the 4 key district offices had conducted the audit. We then divided each of the four groups into two subgroups, for a total of eight strata, based on whether the case involved qualification failures related solely to the failure to amend the plan document in a timely manner in conjunction with tax law changes or other failures in addition to or other than plan amendment;
- Selected a random sample of cases from each of the eight strata for analysis to estimate, using IRS guidelines, the likely applicable Walk-In or VCR program compliance fee that would have been imposed if the sampled plan had availed itself of one of the self-reporting programs;
- Provided IRS program officials with our Walk-In and VCR compliance fee estimates for their review and concurrence; and
- Weighted each sample element to account statistically for all the members of the population, developed estimates of the mean per-participant audit sanction and likely Walk-In and VCR compliance fees, and computed ratios comparing actual audit sanctions to likely Walk-In and VCR Program compliance fees.

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## Alternatives to Audit as a Means to Detect Qualification Failures

To ascertain whether any cost-effective means, other than pension plan audits, have been identified to detect unreported qualification failures, we held discussions with IRS officials, pension practitioners, and other pension interest groups. More specifically, we solicited the views of IRS headquarters officials responsible for managing audits of pension plans,

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managing pension plan voluntary compliance programs, and conducting pension plan compliance research. To obtain the perspectives of pension practitioners, we contacted representatives of the American Bar Association, American Institute of Certified Public Accountants, American Society of Pension Actuaries, and Tax Executives Institute. To obtain the perspective of pension plan sponsors, we contacted the Association of Private Pension and the Welfare Benefit Plans and Employee Retirement Income Security Act Industry Committee. For plan participant viewpoints, we contacted the Pension Rights Center and the American Association of Retired Persons Foundation. For additional views, we contacted the Pension Research Council and the Employee Benefits Research Institute. Not all the groups that we contacted offered opinions on alternatives to audit.

# Results of IRS Compliance Research

**Table II.1: Qualification Failures Among Certain Types of Pension Plans**

Type of plan and plan characteristics	Total	Qualification failure status			Unknown	Total
		No qualification failures	Correctable qualification failures <sup>a</sup>	Uncorrectable qualification failures (revocations)		
<b>Profit-sharing plans<sup>b</sup></b>						
Number of plans	285,000	99.0%	0.8%	0	0.2%	100%
Number of participants	12,178,000	88.6	11.4	0	<sup>c</sup>	100
Amount of assets (billions)	\$320.0	97.5	2.5	0	<sup>c</sup>	100
<b>Money purchase plans<sup>d</sup></b>						
Number of plans	62,000	98.2	1.1	0.2%	0.4	100
Number of participants	2,064,000	99.6	0.3	0.2	<sup>c</sup>	100
Amount of assets (billions)	\$63.9	99.8	0.1	<sup>c</sup>	<sup>c</sup>	100
<b>Owner-Only Plans<sup>e</sup></b>						
Number of plans	182,000	97.4	2.2	0.4	0	100
Number of participants	187,000	97.0	2.6	0.4	0	100
Amount of assets (billions)	\$32.3	97.1	2.8	0.1	0	100
<b>Overall</b>						
Number of plans	529,000	98.3	1.3	0.2	0.2	100
Number of participants	14,429,000	90.2	9.7	<sup>c</sup>	<sup>c</sup>	100
Amount of assets (billions)	\$416.2	97.9	2.1	<sup>c</sup>	<sup>c</sup>	100

Note: Percentages in this table may not sum to 100 because of rounding. The qualification failure data are estimates based on the results of IRS auditing random samples of three types of pension plans as part of a compliance research effort. The 95-percent sampling error for all estimates in the table was less than 3 percentage points. This means that we are 95-percent confident that the range of the reported value,  $\pm 3$  percentage points, will contain the actual population value. For example, if the reported value is 90 percent, we are 95-percent certain that the interval 87 to 93 percent contains the actual value.

<sup>a</sup>Determination based on whether IRS' random audits yielded a closing agreement.

<sup>b</sup>A profit-sharing plan is established and maintained by an employer to provide employees or their beneficiaries with a means to share in the employer's profits. The profit sharing data are based on the results of IRS' random audits done as part of its fiscal year 1998 audit workplan.

<sup>c</sup>Represents less than one-tenth of 1 percent.

<sup>d</sup>A money purchase plan is established and maintained by an employer to provide employees or their beneficiaries with benefits based on fixed employer contributions. The money purchase data are based on the results of IRS' random audits done as a part of its fiscal year 1998 audit workplan.

<sup>e</sup>An owner-only plan is a category of plans in which the business owners and their spouses are the only participants. Most, but not all of these plans, are defined contribution plans. The owner-only data are based on the results of IRS' random audits done as a part of its fiscal year 1995 audit workplan.

Source: Qualification failure estimates were computed by GAO based on IRS research data. Total population data were provided by IRS.

# Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999

**Table III.1: Qualification Failures Identified in IRS Audits and Self-Reported by Pension Plans**

Description of qualification failure	Found by IRS audits	Self-reported by pension plans		Total
		VCR Program	Walk-In Program	
<b>Document failure</b>				
Nonamender (statutory changes)				
Pre-Tax Reform Act of 1986 <sup>a</sup>	35	<sup>b</sup>	77	<b>112</b>
Tax Reform Act of 1986 <sup>c</sup>	144	<sup>b</sup>	293	<b>437</b>
Post-Tax Reform Act of 1986 <sup>d</sup>	45	<sup>b</sup>	96	<b>141</b>
Incomplete or incorrect plan provisions <sup>e</sup>				
Plan participation or coverage requirements	3	<sup>b</sup>	8	<b>11</b>
Contributions or benefit requirements	3	<sup>b</sup>	12	<b>15</b>
Nondiscrimination requirements	3	<sup>b</sup>	12	<b>15</b>
Distribution or payment requirements	0	<sup>b</sup>	4	<b>4</b>
Vesting requirements	4	<sup>b</sup>	11	<b>15</b>
Funding requirements	0	<sup>b</sup>	0	<b>0</b>
Exclusive benefit requirements	0	<sup>b</sup>	0	<b>0</b>
Other requirements	1	<sup>b</sup>	10	<b>11</b>
Amendments adopted within remedial period—401(b)	2	<sup>b</sup>	17	<b>19</b>
Timely adoption of plan (TR 1.401-1(a)(2))	6	<sup>b</sup>	20	<b>26</b>
Other	0	<sup>b</sup>	3	<b>3</b>
<b>Subtotal</b>	<b>246</b>		<b>563</b>	<b>809</b>
<b>Operational failure</b>				
Plan participation or coverage requirements				
Minimum coverage—410(b)	3	2	6	<b>11</b>
Minimum participation—401(a)(26)	0	0	8	<b>8</b>
Excluded employees: age/service time—410(a)(1)(A), 410(a)(2)-(3)	2	27	24	<b>53</b>
Excluded employees: other—410(a)	17	144	8	<b>169</b>
Included ineligible employees—410(a)	4	41	37	<b>82</b>
Timely participation—410(a)(4)	12	9	12	<b>33</b>
Participation or coverage—other: 410, (TR 1.401-1(a)(2))	7	19	6	<b>32</b>
Contributions or benefit requirements				
Limit on employee contributions—401(a)(30), 402(g)	4	41	3	<b>48</b>
Limit on employer/employee contributions—415	24	125	24	<b>173</b>
Misallocation or miscalculation of contributions (TR 1.401-1(a)(2)) <sup>f</sup>	27	253	69	<b>349</b>
Misallocation of forfeitures (TR 1.401-1(a)(2)) <sup>f</sup>	3	55	9	<b>67</b>
Misallocation of earnings (TR 1.401-1(a)(2)) <sup>f</sup>	3	12	3	<b>18</b>
Contributions or benefits—other: (TR 1.401-1(a)(2))	15	120	31	<b>166</b>
Nondiscrimination requirements				
ADP testing—401(k)(3), (8)	31	91	17	<b>139</b>
ACP testing—401(m)(2), (6)	14	35	11	<b>60</b>
Multiple use test—TR 1.401(m)-2(b)	3	11	2	<b>16</b>
General nondiscrimination rules—401(a)(4)	19	2	9	<b>30</b>
Salary cap—401(a)(17)	23	63	15	<b>101</b>
Top heavy rules—401(a)(10), 416	10	55	16	<b>81</b>
Social Security integration/permitted disparity—401(l)	3	2	10	<b>15</b>
Nondiscrimination—other: (TR 1.401-1(a)(2)) <sup>g</sup>	3	0	1	<b>4</b>
Distribution or payment requirements				
Required minimum distributions—401(a)(9)	17	79	13	<b>109</b>

**Appendix III**  
**Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999**

Description of qualification failure	Found by IRS audits	Self-reported by pension plans		Total
		VCR Program	Walk-In Program	
Commencement of benefits—401(a)(14)	5	13	3	21
In-service distributions—401(k)(10)	1	23	8	32
Rollover requirements—401(a)(31)	2	12	10	24
Loan requirements—72(p), (TR 1.401-1(a)(2)) <sup>e</sup>	6	30	34	70
Hardship distributions—401(k)(2)	2	35	5	42
Small lump-sum distributions—411(a)(11)	3	39	7	49
Distributions made prior to distributable event: 401(a), (k)	1	14	5	20
Distributions/payments—other: (TR 1.401-1(a)(2)) <sup>e</sup>	3	78	13	94
<b>Vesting requirements</b>				
Vesting rules—411(a)	15	74	31	120
Accrued benefits—411(b)	1	13	7	21
Plan amendment—effect on benefits—411(d)(6)	3	0	18	21
Plan termination—effect on benefits—411(d)(3)	3	2	24	29
Vesting—other: 411, (TR 1.401-1(a)(2)) <sup>e</sup>	10	11	3	24
<b>Funding requirements</b>				
Failure to make contributions to plan (TR 1.401-1(a)(2)) <sup>e</sup>	1	18	13	32
Funding of plan—other (TR 1.401-1(a)(2)) <sup>e</sup>	2	28	14	44
Exclusive benefit requirements—401(a)(2)	0	0	2	2
<b>Other requirements</b>				
Merger/consolidation—401(a)(12), 414(l)	1	2	0	3
Assignment/alienation—401(a)(13)(A)	2	4	16	22
Joint and survivor annuity/spousal protection—401(a)(11), 417	17	54	26	97
Aggregation rules—414(b),(c)	0	2	7	9
Employee stock option plan rules—401(a)(28)	1	9	0	10
Other: 401(a), (TR 1.401-1(a)(2))	6	34	14	54
<b>Subtotal</b>	<b>329</b>	<b>1,680</b>	<b>594</b>	<b>2,603</b>
<b>Demographic failure</b>				
Nondiscriminatory contributions/benefits—401(a)(4)	10	<sup>b</sup>	10	20
Minimum participation requirements—401(a)(26)	6	<sup>b</sup>	7	13
Minimum coverage requirements—410(b)	6	<sup>b</sup>	7	13
<b>Subtotal</b>	<b>22</b>		<b>24</b>	<b>46</b>
<b>Total number of failures</b>	<b>597</b>	<b>1,680</b>	<b>1,181</b>	<b>3,458</b>

Note: Values for the number of failures for the VCR Program and totals are estimates. The 95-percent confidence interval around each estimate is no more than 20 failures away from the value of the estimate. Audit and Walk-in Program data represent all cases.

<sup>a</sup>Plans failed to amend timely for law changes made before the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>b</sup>Not applicable.

<sup>c</sup>Plans failed to amend timely for tax law changes made in the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>d</sup>Plans failed to amend timely for tax law changes made after the Tax Reform Act of 1986.

<sup>e</sup>Specific requirements included in these general categories are described under plan operational failures.

<sup>f</sup>Failures in this category generally represent failures to operate according to relevant plan provisions.

Source: GAO review of IRS closing agreements and compliance statements.

**Appendix III**  
**Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999**

**Table III.2: Qualification Failures by Plan Type**

Description of qualification failure	Defined benefit	Defined contribution				Missing data	Total
		Profit sharing	Money purchase	Stock bonus	Other		
<b>Document failure</b>							
Nonamender (statutory changes)							
Pre-Tax Reform Act of 1986 <sup>a</sup>	16	29	21	3	3	40	112
Tax Reform Act of 1986 <sup>b</sup>	67	162	45	16	17	130	437
Post-Tax Reform Act of 1986 <sup>c</sup>	20	91	10	4	2	14	141
Incomplete or incorrect plan provisions: <sup>d</sup>							
Plan participation or coverage requirements	1	8	1	0	1	0	11
Contributions or benefit requirements	1	8	2	0	1	3	15
Nondiscrimination requirements	4	7	3	0	1	0	15
Distribution or payment requirements	0	3	0	0	0	1	4
Vesting requirements	5	7	0	0	0	3	15
Funding requirements	0	0	0	0	0	0	0
Exclusive benefit requirements	0	0	0	0	0	0	0
Other requirements	2	7	1	0	0	1	11
Amendments adopted within remedial period—401(b)	4	9	3	0	1	2	19
Timely adoption of plan (TR 1.401-1(a)(2))	0	16	7	0	0	3	26
Other	0	3	0	0	0	0	3
<b>Subtotal</b>	<b>120</b>	<b>350</b>	<b>93</b>	<b>23</b>	<b>26</b>	<b>197</b>	<b>809</b>
<b>Operational failure</b>							
Plan participation or coverage requirements							
Minimum coverage—410(b)	1	8	2	0	0	0	11
Minimum participation—401(a)(26)	0	5	1	0	0	2	8
Excluded employees: age/service time—410(a)(1)(A), 410(a)(2)-(3)	9	35	5	0	0	4	53
Excluded employees: other—410(a)	11	132	24	2	0	1	169
Included ineligible employees—410(a)	3	64	6	1	2	6	82
Timely participation—410(a)(4)	1	24	5	0	0	3	33
Participation or coverage—other: 410, (TR 1.401-1(a)(2))	2	18	5	0	5	3	32
Contributions or benefit requirements							
Limit on employee contributions—401(a)(30), 402(g)	0	46	1	0	1	0	48
Limit on employer/employee contributions—415	17	129	11	3	5	9	173
Misallocation or miscalculation of contributions (TR 1.401-1(a)(2)) <sup>e</sup>	76	222	28	3	4	17	349
Misallocation of forfeitures (TR 1.401-1(a)(2)) <sup>e</sup>	0	55	5	3	5	0	67
Misallocation of earnings (TR 1.401-1(a)(2)) <sup>e</sup>	0	15	2	2	0	0	18
Contributions or benefits—other (TR 1.401-1(a)(2))	14	126	14	1	3	8	166
Nondiscrimination requirements							
ADP testing—401(k)(3), (8)	0	133	0	2	0	4	139
ACP testing—401(m)(2), (6)	2	52	3	2	1	1	60
Multiple use test—TR 1.401(m)-2(b)	0	14	0	2	0	0	16
General nondiscrimination rules—401(a)(4)	2	19	7	0	0	2	30
Salary cap—401(a)(17)	5	73	18	0	2	3	101
Top heavy rules—401(a)(10), 416	4	69	6	0	0	2	81
Social Security integration/permitted disparity—401(l)	5	6	3	0	0	1	15
Nondiscrimination—other	0	3	1	0	0	0	4
Distribution or payment requirements							
Required minimum distributions—401(a)(9)	46	48	11	2	0	2	109

**Appendix III**  
**Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999**

Description of qualification failure	Defined benefit	Defined contribution				Missing data	Total
		Profit sharing	Money purchase	Stock bonus	Other		
Commencement of benefits-401(a)(14)	13	6	0	0	1	2	21
In-service distributions-401(k)(10)	1	20	4	0	3	5	32
Rollover requirements-401(a)(31)	1	18	3	0	1	1	24
Loan requirements-72(p), (TR 1.401-1(a)(2)) <sup>e</sup>	2	38	6	7	5	13	70
Hardship distributions-401(k)(2)	0	41	0	0	0	1	42
Small lump-sum distributions-411(a)(11)	27	18	1	0	3	0	49
Distributions made prior to distributable event-401(a), (k)	3	12	3	0	0	3	20
Distributions/payments-other:(TR 1.401-1(a)(2))	17	60	1	9	0	7	94
<b>Vesting requirements</b>							
Vesting rules-411(a)	43	61	9	2	0	6	120
Accrued benefits-411(b)	17	5	0	0	0	0	21
Plan amendment-effect on benefits-411(d)(6)	7	8	4	0	0	2	21
Plan termination-effect on benefits-411(d)(3)	21	5	0	0	1	2	29
Vesting-other(TR 1.401-1(a)(2))	5	17	1	0	0	1	24
<b>Funding requirements</b>							
Failure to make contributions to plan (TR 1.401-1(a)(2)) <sup>e</sup>	0	17	7	4	0	4	32
Funding of plan-other (TR 1.401-1(a)(2)) <sup>e</sup>	0	31	8	0	3	3	44
Exclusive benefit requirements-401(a)(2)	0	1	1	0	0	0	2
<b>Other requirements</b>							
Merger/consolidation-401(a)(12), 414(l)	2	1	0	0	0	0	3
Assignment/alienation-401(a)(13)(A)	1	14	0	0	5	2	22
Joint and survivor annuity/spousal protection-401(a)(11), 417	43	32	16	2	1	2	97
Aggregation rules-414(b), (c)	1	7	1	0	0	0	9
Employee stock option plan rules-401(a)(28)	0	8	0	2	0	0	10
Other(TR 1.401-1(a)(2))	3	25	8	10	2	6	54
<b>Subtotal</b>	<b>403</b>	<b>1,738</b>	<b>228</b>	<b>56</b>	<b>51</b>	<b>127</b>	<b>2,603</b>
<b>Demographic failure</b>							
Nondiscriminatory contributions/benefits-401(a)(4)	0	12	4	0	0	4	20
Minimum participation requirements-401(a)	2	5	2	0	0	4	13
Minimum coverage requirements-410(b)	3	5	3	0	0	2	13
<b>Subtotal</b>	<b>5</b>	<b>22</b>	<b>9</b>	<b>0</b>	<b>0</b>	<b>10</b>	<b>46</b>
<b>Total number of failures</b>	<b>528</b>	<b>2,110</b>	<b>330</b>	<b>79</b>	<b>77</b>	<b>334</b>	<b>3,458</b>

Note: The 95-percent confidence interval around each estimate is no more than 20 failures away from the value of the estimate.

<sup>a</sup>Plans failed to amend timely for law changes made before the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>b</sup>Plans failed to amend timely for tax law changes made in the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>c</sup>Plans failed to amend timely for tax law changes made after the Tax Reform Act of 1986.

<sup>d</sup>Specific requirements included in these general categories are described under plan operational failures.

<sup>e</sup>Failures in this category generally represent failures to operate according to relevant plan provisions.

Source: GAO review of IRS closing agreements and compliance statements.

**Appendix III**  
**Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999**

**Table III.3: Qualification Failures by Plan Size**

Description of qualification failure	Number of participants							Missing data	Total
	10 or fewer	11-50	51-100	101-300	301-1,000	1,000 - 10,000	More than 10,000		
<b>Document failure</b>									
Nonamender (statutory changes)									
Pre-Tax Reform Act of 1986 <sup>a</sup>	81	22	2	2	1	0	0	4	112
Tax Reform Act of 1986 <sup>b</sup>	301	77	19	20	10	1	0	9	437
Post-Tax Reform Act of 1986 <sup>c</sup>	58	41	13	14	10	3	0	2	141
Incomplete or incorrect plan provisions: <sup>d</sup>									
Plan participation or coverage requirements	0	3	3	1	2	2	0	0	11
Contributions or benefit requirements	3	6	1	2	0	1	0	2	15
Nondiscrimination requirements	4	0	5	2	3	1	0	0	15
Distribution or payment requirements	0	0	0	0	3	0	0	1	4
Vesting requirements	2	3	1	3	2	2	0	2	15
Funding requirements	0	0	0	0	0	0	0	0	0
Exclusive benefit requirements	0	0	0	0	0	0	0	0	0
Other requirements	0	2	2	2	3	2	0	0	11
Amendments adopted within remedial period—401(b)	1	10	3	1	4	0	0	0	19
Timely adoption of plan—(TR 1.401-1(a)(2))	5	11	2	3	2	1	0	2	26
Other	2	0	1	0	0	0	0	0	3
<b>Subtotal</b>	<b>457</b>	<b>175</b>	<b>52</b>	<b>50</b>	<b>40</b>	<b>13</b>	<b>0</b>	<b>22</b>	<b>809</b>
<b>Operational failure</b>									
Plan participation or coverage requirements									
Minimum coverage—410(b)	2	3	1	4	1	0	0	0	11
Minimum participation—401(a)(26)	4	3	0	0	0	0	0	1	8
Excluded employees: age/service time—410(a)(1)(A), 410(a)(2)-(3)	8	9	7	6	6	12	4	1	53
Excluded employees: other—410(a)	31	54	24	22	12	24	2	1	169
Included ineligible employees—410(a)	1	21	15	11	10	20	0	4	82
Timely participation—410(a)(4)	5	13	5	4	4	1	0	2	33
Participation or coverage—other: 410, (TR 1.401-1(a)(2))	5	11	6	0	10	0	0	2	32
Contributions or benefit requirements									
Limit on employee contributions—401(a)(30), 402(g)	5	12	6	11	8	5	2	0	48
Limit on employer/employee contributions—415	30	33	16	25	28	30	6	6	173
Misallocation or miscalculation of contributions (TR 1.401-1(a)(2)) <sup>e</sup>	45	55	28	65	33	75	41	7	349
Misallocation of forfeitures (TR 1.401-1(a)(2)) <sup>e</sup>	4	11	12	25	12	3	0	0	67
Misallocation of earnings (TR 1.401-1(a)(2)) <sup>e</sup>	4	9	2	4	0	0	0	0	18
Contributions or benefits—other	12	42	11	39	28	24	5	5	166
Nondiscrimination requirements									
ADP testing—401(k)(3), (8)	13	36	21	36	15	15	1	3	139
ACP testing—401(m)(2), (6)	4	13	13	13	4	10	3	0	60
Multiple use test—TR 1.401(m)-2(b)	0	2	3	5	3	4	0	0	16
General nondiscrimination rules—401(a)(4)	17	6	1	5	1	0	0	0	30
Salary cap—401(a)(17)	28	13	16	15	20	6	4	0	101
Top heavy rules—401(a)(10), 416	21	41	8	3	5	3	0	0	81
Social Security integration/permitted disparity—401(l)	5	6	2	0	0	2	0	0	15

**Appendix III**  
**Results of Our Analyses of Pension Plan Qualification Failures Resolved in Fiscal Year 1999**

Description of qualification failure	Number of participants								Total
	10 or fewer	11-50	51-100	101-300	301-1,000	1,000 - 10,000	More than 10,000	Missing data	
Nondiscrimination—other (TR 1.401-1(a)(2))	3	0	0	0	0	1	0	0	4
Distribution or payment requirements									
Required minimum distributions—401(a)(9)	11	20	7	6	13	34	19	0	109
Commencement of benefits—401(a)(14)	0	1	0	3	1	9	8	0	21
In-service distributions—401(k)(10)	9	10	1	4	5	2	0	2	32
Rollover requirements—401(a)(31)	0	13	3	3	1	2	2	1	24
Loan requirements—72(p), (TR 1.401-1(a)(2)) <sup>e</sup>	17	15	2	10	7	8	2	10	70
Hardship distributions—401(k)(2)	0	5	1	17	7	10	2	1	42
Small lump-sum distributions—411(a)(11)	2	5	3	7	13	13	5	0	49
Distributions made prior to distributable event—401(a),(k)	6	6	2	4	0	2	0	1	20
Distributions/payments—other (TR 1.401-1(a)(2))	0	25	8	25	11	19	2	4	94
Vesting requirements									
Vesting rules—411(a)9	10	22	10	9	19	36	13	3	120
Accrued benefits—411(b)	1	4	0	1	4	11	1	0	21
Plan amendment—effect on benefits—411(d)(6)	4	1	1	4	6	4	0	1	21
Plan termination—effect on benefits—411(d)(3)	22	2	3	0	0	2	0	0	29
Vesting—Other (TR 1.401-1(a)(2))	3	9	1	3	4	4	0	1	24
Funding requirements									
Failure to make contributions to plan (TR 1.401-1(a)(2)) <sup>e</sup>	7	8	1	5	4	5	0	2	32
Funding of plan—other (TR 1.401-1(a)(2)) <sup>e</sup>	5	3	7	10	9	11	0	0	44
Exclusive benefit requirements—401(a)(2)	0	1	1	0	0	0	0	0	2
Other requirements									
Merger/Consolidation—401(a)(12), 414(l)	0	1	0	0	0	0	2	0	3
Assignment/Alienation—401(a)(13)(A)	3	7	0	3	7	1	0	1	22
Joint and Survivor Annuity/spousal protection—401(a)(11), 417	12	21	6	8	8	29	13	0	97
Aggregation Rules—414(b), (c)	2	1	2	3	0	1	0	0	9
Employee stock option plan rules—401(a)(28)	1	4	2	0	2	0	2	0	10
Other—401(a),(TR 1.401-1(a)(2))	8	13	7	9	0	12	2	4	54
<b>Subtotal</b>	<b>368</b>	<b>586</b>	<b>262</b>	<b>426</b>	<b>317</b>	<b>447</b>	<b>137</b>	<b>60</b>	<b>2,603</b>
<b>Demographic failure</b>									
Nondiscriminatory contributions/benefits – 401(a)(4)	11	3	4	2	0	0	0	0	20
Minimum participation requirements – 401(a)(26)	10	2	0	0	0	0	0	1	13
Minimum coverage requirements – 410(b)	9	2	1	1	0	0	0	0	13
<b>Subtotal</b>	<b>30</b>	<b>7</b>	<b>5</b>	<b>3</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1</b>	<b>46</b>
<b>Total number of failures</b>	<b>855</b>	<b>768</b>	<b>319</b>	<b>479</b>	<b>357</b>	<b>460</b>	<b>137</b>	<b>83</b>	<b>3,458</b>

Note: The 95 percent confidence interval around each estimate is no more than 20 failures away from the value of the estimate.

<sup>a</sup>Plans failed to amend timely for law changes made before the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>b</sup>Plans failed to amend timely for tax law changes made in the Tax Reform Act of 1986 and may also have failed to amend for subsequent tax law changes.

<sup>c</sup>Plans failed to amend timely for tax law changes made after the Tax Reform Act of 1986.

<sup>d</sup>Specific requirements included in these general categories are described under plan operational failures.

<sup>e</sup>Failures in this category generally represent failures to operate according to relevant plan provisions.

Source: GAO review of IRS closing agreements and compliance statements.

# Comments From the Internal Revenue Service



COMMISSIONER

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

July 21, 2000

Ms. Cornelia M. Ashby  
Associate Director, Tax Policy  
and Administration Issues  
United States General Accounting Office  
Washington, DC 20548

Dear Ms. Ashby:

Thank you for the opportunity to review and comment on your draft report entitled *Pension Plans: IRS Programs for Resolving Deviations from Tax-Exemption Requirements*. We have reviewed the report and for the most part find that it fairly and accurately describes the Internal Revenue Service (IRS) efforts over the past decade to partner with plan sponsors to ensure that plans meet requirements through voluntary compliance. While the report focuses on the compliance and correction programs that involve IRS oversight, we believe we do not supervise most of the voluntary compliance efforts undertaken by plan sponsors because they are corrected through our *self-correction* program<sup>1</sup>. Thus, while mindful of the scope of your report, by eliminating from the report all qualification failures that are *self-corrected* under this much-used program, we are concerned that readers may underestimate the incidence of qualification failures or the extent of voluntary compliance.

We appreciate your reference to the fact that the IRS is planning to improve the EPCRS. The programs within the EPCRS are under close scrutiny, both by the IRS and by our customers. These programs are the result of an evolving process and are the products of a continued partnership between the IRS and its public stakeholders. As stated in your report on page 15, the IRS is establishing

<sup>1</sup> The Administrative Policy Regarding Self-Correction (APRSC), described briefly in footnote one of your report, is one of four programs within the Employee Plans Compliance Resolution System (EPCRS) that is available for sponsors of tax-qualified plans. It permits a sponsor of a tax-qualified plan to self-correct significant qualification failures within a specified time without either IRS supervision or payment of a fee or sanction. Under APRSC, a plan sponsor can correct an insignificant qualification failure on discovering an error, or may correct the error on audit with IRS supervision.

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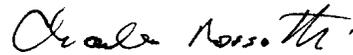
**Appendix IV**  
**Comments From the Internal Revenue Service**

-2-

new positions responsible for improving coordination and predictability among the EPCRS programs. We are, in fact, improving an existing structure designed to promote consistency and coordination. These improvements are a part of our effort to restructure the IRS into an organization that provides for excellent customer service. Fundamental to this change is our providing end-to-end responsibility within each function of the IRS. As a result, we have eliminated the former parallel reporting structure that distinguished between the National Office and the field offices.

Thank you again for this opportunity to respond to your report. If you have any questions or concerns, please contact Carol Gold, Director of Employee Plans, Tax Exempt and Government Entities Division at (202) 622-8100.

Sincerely,



Charles O. Rossotti

# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Cornelia M. Ashby, (202) 512-9110  
Thomas Richards, (202) 512-9110

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## Acknowledgments

In addition to those named above, Ed Nannenhorn, Ellen Rominger, Wendy Ahmed, Susan Baker, Robert DeRoy, John Mingus, and James Wozny made key contributions to this report.

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