



*The Employee Plans Function Has
Improved the Process for Selecting
Retirement Plans for Examination*

May 10, 2011

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

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HIGHLIGHTS

THE EMPLOYEE PLANS FUNCTION HAS IMPROVED THE PROCESS FOR SELECTING RETIREMENT PLANS FOR EXAMINATION

Highlights

Final Report issued on May 10, 2011

Highlights of Reference Number: 2011-10-050 to the Acting Internal Revenue Service Commissioner for the Tax Exempt and Government Entities Division.

IMPACT ON TAXPAYERS

The primary objective of Employee Plans function examinations is to determine if retirement plans are operating in accordance with the tax-exempt qualification provisions of the Internal Revenue Code and within the terms of the plan document. If a retirement plan is not in compliance, the Employee Plans function works with retirement plan officials to resolve examination issues and bring the retirement plan back into compliance. The Employee Plans function has improved its ability to select examinations that identify noncompliance, as evidenced by an increase in the percentage of examinations where noncompliance with the Internal Revenue Code has been detected. Ensuring that plans comply with all applicable statutes and regulations provides plan participants with greater assurance that promised benefits will be available upon retirement.

WHY TIGTA DID THE AUDIT

TIGTA initiated this audit in response to a request from the Internal Revenue Service to review the Employee Plans function's selection methodology for risk-based targeted examinations. Our overall objective was to determine whether the Employee Plans function's processes for selecting examination cases allow for emerging issues to be considered and take into account the risk of noncompliance for the retirement plan universe.

WHAT TIGTA FOUND

TIGTA determined that the Employee Plans function's methods for selecting examinations have evolved over the years and examinations are now identifying a larger percentage of retirement plans that are noncompliant. Identifying noncompliance through the examination program ensures that Employee Plans function resources are being used wisely, and reduces the burden on plan sponsors and administrators by focusing on retirement plans most likely to have compliance issues.

The Employee Plans function has accomplished this improvement by developing methods for selecting examination cases that allow for emerging issues to be considered, while taking into account the risk of noncompliance for the retirement plan universe. For example, the most productive examinations (those that identify retirement plans that are noncompliant) have been the result of special projects, abusive transactions, and referrals. Over the past five years, these three areas have consistently identified the highest degree of noncompliance. In addition, the Employee Plans function's risk-based examinations are becoming more productive based on historical results of examinations from particular market segments.

WHAT TIGTA RECOMMENDED

TIGTA made no recommendations in this report. Tax Exempt and Government Entities Division management reviewed the report before it was issued and offered clarifying comments and suggestions, which have been taken into account.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

May 10, 2011

MEMORANDUM FOR ACTING COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

Michael R. Phillips

FROM:

Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT:

Final Audit Report – The Employee Plans Function Has Improved the
Process for Selecting Retirement Plans for Examination
(Audit # 201110002)

This report presents the results of our review to determine whether the Employee Plans function's processes for selecting examination cases allow for emerging issues to be considered and take into account the risk of noncompliance for the retirement plan universe. This review was requested by the Internal Revenue Service and is included in our Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

We made no recommendations in this report. Tax Exempt and Government Entities Division management reviewed the report before it was issued and offered clarifying comments and suggestions, which were taken into account.

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



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Background

There are over 867,000 retirement plans in existence with assets totaling approximately \$5.3 trillion. The Employee Retirement Income Security Act¹ sets uniform standards to assure that employee benefit plans are established and maintained in a fair and financially sound manner. The Internal Revenue Service (IRS) Employee Plans function is responsible for ensuring sponsors of employee retirement plans comply with applicable statutes and regulations that are designed to ensure that employees receive promised benefits. The Employee Plans function accomplishes this by helping customers understand and comply with applicable tax laws and by protecting the public interest by applying the tax law with integrity and fairness to all.

Retirement plan assets and participants' benefits are protected through a fair, objective, and effective compliance program. One part of an effective compliance program is examinations. The primary objective of examinations is to determine if retirement plans are operating in accordance with the tax-exempt qualification provisions of the Internal Revenue Code and within the terms of the plan document, which is designed to ensure that retirement plan participants receive the benefits promised by the plan.²

Examinations determine if retirement plans are operating in accordance with tax-exempt laws and the terms of the plan to ensure plan participants receive promised benefits.

Examinations are performed to ensure that retirement plan sponsors are making contributions to the plan as required, assets truly exist to satisfy liabilities and are properly classified, and retirement plans are operating in accordance with the plan design. If a retirement plan is not in compliance, Employee Plans function examiners work with retirement plan officials to resolve examination issues and bring the retirement plan back into compliance. While the primary goal is for plans to make changes necessary to fully comply, the IRS can assess penalties, taxes, and interest charges, or completely disqualify a retirement plan from tax-exempt status if major violations are found.

Employee Plans function management was using the following priority order for assigning examination work based on the timing of workload needs, the location of case work, and the availability of resources.

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 The plan document details how the plan operates and outlines plan requirements.



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- 1) **Special Projects and Abusive Tax Avoidance Transactions (hereafter referred to as abusive transactions)** – Special projects are used to strategically select examinations based on the Employee Plans function’s research program, changes made to the Annual Return/Report of Employee Benefit Plan (Form 5500) return, historical examination data, and other emerging issues such as legislative changes. In addition, the Employee Plans function participates in an IRS-wide effort to address abusive tax shelter schemes and promotions. When selecting returns to be examined, special projects and abusive transactions are given the highest priority.
- 2) **Referrals** – The Employee Plans function receives referrals throughout the year when there are questions or concerns that employers or retirement plan sponsors may not be complying with the Internal Revenue Code sections governing employee benefit plans. Referrals originate from a variety of sources both within and outside the IRS.
- 3) **Risk-Based Targeted (hereafter referred to as risk-based) Examinations** – In Fiscal Year 2008, the Tax Exempt and Government Entities Division issued a report on compliance risk assessments that defined what it considered to be noncompliance for employee retirement plans and developed a market segment framework³ for selecting examinations to be conducted. The framework divided the population of retirement plans into 20 different industry segments, each with 11 different types of retirement plans.

Between Fiscal Years 2002 and 2008, the Employee Plans function reduced the number of market segments and developed a risk-based approach for selecting examinations. The Employee Plans function accomplished this by identifying market segments for which it had completed examinations for a sample of plans and found significant noncompliance⁴ in either the entire market segment or parts of it. The above report also described how the process evolved, outlined examination results, and recommended risk-based segments for further evaluation as a source for selecting examinations. A subsequent report in August 2010 described how the Employee Plans Examinations function was winding down its evaluation of examination results for market segments and using the knowledge gained from it to move forward with the risk-based approach that is currently being used.
- 4) **Other** – Other sources of examinations include general case work and training cases, which are used to fill a specific business need. General case work includes returns which do not fall under a specific category such as those above and which are assigned to balance return assignments to field staff for efficient use of travel funds. Training cases are generally assigned to less-experienced or newly hired employees and normally involve simpler issues.

³ The Employee Plans function Market Segment Framework categorizes the retirement plan universe by type of business (e.g., manufacturing) and type of retirement plan (e.g., profit sharing).

⁴ Significant noncompliance for a market segment signifies that 30 percent or more of all returns examined from the segment resulted in a change to the Form 5500 return or the retirement plan document.



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This review was performed at the Tax Exempt and Government Entities Division Employee Plans Examination function in Baltimore, Maryland, during the period September 2010 to February 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

The Employee Plans function has improved its ability to select retirement plan examinations that identify noncompliance, as evidenced by an increase in the percentage of examinations where noncompliance with the Internal Revenue Code has been detected. Examinations are performed to ensure that plan sponsors are making contributions to the plan as required, assets truly exist to satisfy the liabilities and are properly classified, and plans are operating in accordance with the plan design. Identifying noncompliance through the examination program ensures that Employee Plans function resources are being used wisely and reduces the burden on other plan sponsors and administrators by focusing on retirement plans most likely to have compliance issues.

The Employee Plans function has accomplished this improvement by developing methods for selecting examination cases that allow for emerging issues to be considered, while taking into account the historical risk of noncompliance for the retirement plan universe. For example, the most productive examinations⁵ have been the result of special projects, abusive transactions, and referrals. Over the past 5 years, these 3 areas have consistently identified the highest degree of noncompliance. In addition, the Employee Plans function's risk-based examinations are becoming more productive based on historical results of examinations from particular market segments.

Examination Selection Methods Have Evolved and Now Result in More Noncompliance Being Detected

To assist the Employee Plans function in meeting its mission of protecting retirement plan assets and the benefits of plan participants, the examination program should focus its resources on identifying noncompliant plans and bringing them back into compliance. During our audits,⁶ we have determined the Employee Plans function's methods for selecting examinations have evolved over the years and examinations are now identifying a larger percentage of retirement plans that are noncompliant (as evidenced by a change being made to the retirement plan return as a result of an examination). Figure 1 shows the increase in changes made to retirement plan returns over the past 5 fiscal years.

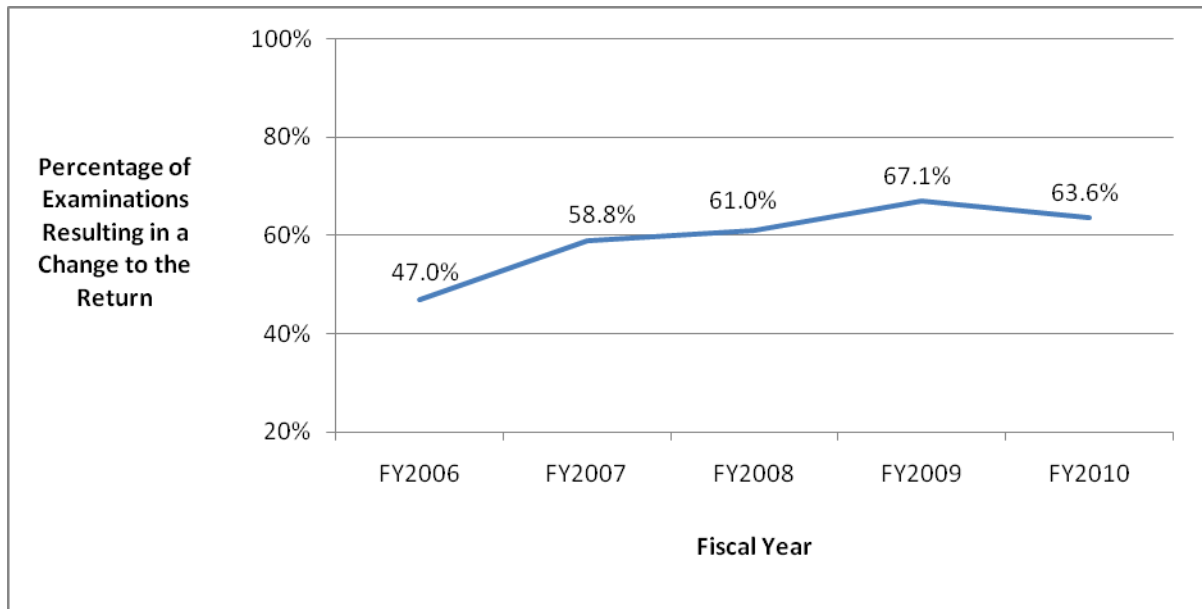
⁵ "Most productive examinations" are those which result in identifying retirement plans that are noncompliant with applicable laws and regulations.

⁶ See Appendix IV for details of our past audit work concerning the Employee Plans function's examination selection methods.



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**Figure 1: Percentage of Examinations Resulting in a Change to the Return
(Fiscal Years 2006–2010)**



Source: Audit Information Management System Reports for Fiscal Years 2006 to 2010.

The reason the Employee Plans function has been able to select examinations that reveal more noncompliance than in the past is that it has conducted analyses of historical results, continually updated its areas of emphasis as more knowledge is gained about the retirement plan universe, and considered issues emerging in the retirement plan community. This has resulted in increased identification of noncompliant areas in retirement plans.

Over the last 5 years, one of the Employee Plans Examination function's highest priorities has been examinations related to special projects, abusive transactions, and referrals. Historically, these sources generally resulted in a change to the tax return at a rate higher than other types of examinations and have increasingly higher change rates over the past several years. For example, the change rate for special project, abusive transaction, and referral examinations increased from 67 to 81 percent from Fiscal Year 2006 to Fiscal Year 2010, and exceeded the overall change rate shown in Figure 1 for Employee Plans examinations in each of these fiscal years. By Fiscal Year 2010, the number of returns examined in these three areas nearly doubled and the rate at which there was a change to the return climbed to over 80 percent. The shift in focus to these three areas is a logical progression because these examinations result in a higher amount of noncompliance being detected than the amount uncovered by other methods.

The Employee Plans function also developed a risk-based approach to concentrate on market segments or parts of market segments most likely to be noncompliant. By mid-Fiscal Year 2006, the Employee Plans function summarized results from segments of its risk-based examination program for which there were a sufficient number of completed examinations. From that point



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forward, the only risk-based returns assigned to field examination staff were from segments for which the Employee Plans function had found significant noncompliance either in the entire segment or in parts within a segment in its baseline analysis.⁷

Since that time, there has been an overall increase in the amount of noncompliance detected by risk-based examinations. This correlates with the Employee Plans function's continuing validation of its market segments and adopting a risk-based approach to focus on particularly noncompliant market segments or parts of market segments.

Figure 2 shows the progression of the Employee Plans function's workload selection for Fiscal Years 2006 through 2010.

**Figure 2: Percentage of Completed Employee Plans Examinations
by Major Program Areas (Fiscal Years 2006–2010)**

Fiscal Year	Special Projects, Abusive Transactions, and Referrals	Risk-Based	All Other	Total⁸
2006	23.1%	74.3%	2.6%	100.0%
2007	34.3%	61.6%	4.0%	100.0%
2008	33.9%	62.8%	3.3%	100.0%
2009	47.5%	50.3%	2.2%	100.0%
2010	42.9%	55.1%	2.0%	100.0%

Source: Audit Information Management System Reports for Fiscal Years 2006 to 2010.

During Fiscal Year 2006, Employee Plans function staff also began using a focused examination methodology when analyzing returns. Using this process, Employee Plans function examination staff narrows the scope of the examination. Initially, the examinations are assigned three pre-identified issues that are required for consideration (based on historical data and other criteria). The examiners are then expected to perform a pre-audit analysis, using various resources at their disposal, including analyzing the internal controls and focusing on areas where internal controls are weak. If initial contact with the taxpayer shows good internal controls and no areas of concern, the scope of the examination can be limited; however, the examiner must still address the three pre-identified issues. Conversely, if the examination staff identifies any areas of concern, the examination can be expanded to ensure the plan is compliant in these areas.

Collectively, the implementation of these changes resulted in an overall increase in the number of examined returns that closed with a change to the return. There were noteworthy improvements over the past 5 fiscal years in the percentage of examinations that resulted in a

⁷ The Employee Plans function's market segment approach involved completing examinations in segments deemed most likely to be noncompliant and identifying baseline compliance levels for those segments.

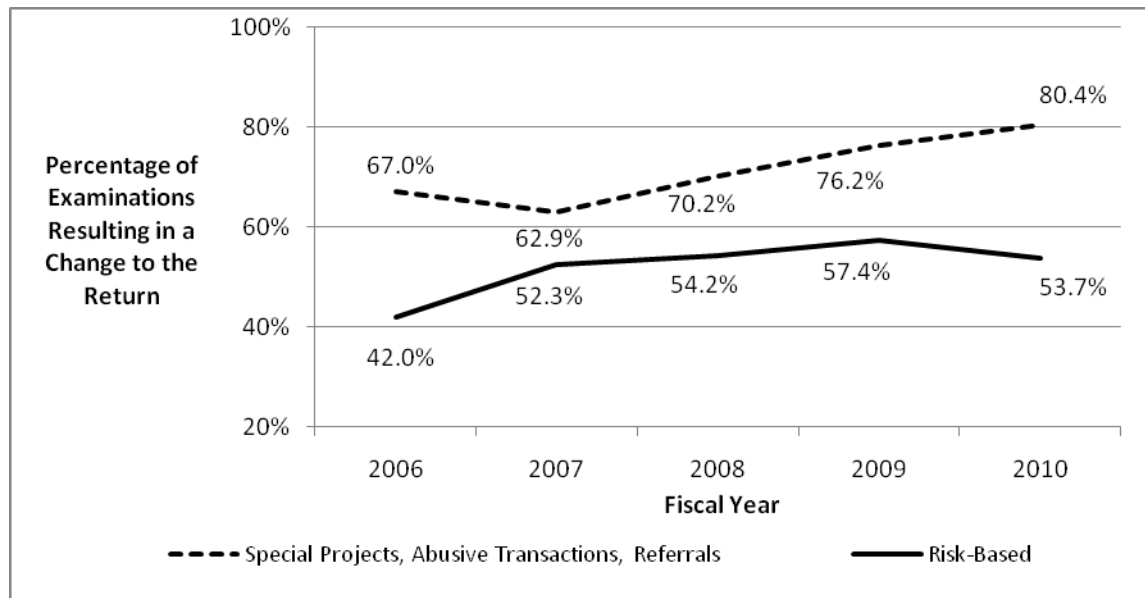
⁸ Percentage may not equal 100 percent due to rounding.



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change for special projects, abusive transactions, referrals, and risk-based examinations, as illustrated in Figure 3.

**Figure 3: Percentage of Examinations Resulting in a Change to the Return
(Fiscal Years 2006–2010)**



Source: Audit Information Management System Reports for Fiscal Years 2006 to 2010.

The following sections provide additional details on the results of:

- Special project, abusive transaction, and referral examinations.
- Risk-based examinations.
- Other types of examinations.

Special project, abusive transaction, and referral examinations

In recent years, the Employee Plans examination program's emphasis has slowly shifted to the development of special projects which combine the quantitative analyses of historical data (similar to the risk-based model) with other information, such as recent changes to the laws governing employee benefit plans, to select returns for examination. In addition, the Employee Plans function has increased its focus on abusive transactions designed to obtain tax benefits not allowed by law.

Special project and abusive transaction examinations allow the Employee Plans function the flexibility to address issues across market segment boundaries and address any sector of the retirement plan universe. This means that the Employee Plans function can potentially address plans in market segments that are not currently being addressed by the risk-based examination approach. Future special projects may also be able to address sectors of the retirement plan



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universe that are not required to annually file a Form 5500.⁹ Plans are underway to determine techniques for accomplishing this.

Referrals can come from within the Employee Plans function through its Employee Plans Compliance Unit, from other IRS operating divisions that may be conducting tax return examinations of an individual's or company's books and records, or outside sources such as the Department of Labor. Referrals are distributed as part of the regular workload of Employee Plans Examination function groups in lieu of being considered discretionary work. Referral examinations have consistently resulted in very high rates of noncompliance and, as a result, a high emphasis is placed on ensuring that all referrals are examined. The percentage of noncompliance detected for referrals ranged from 65.5 percent to 83.8 percent from Fiscal Year 2006 to Fiscal Year 2010.

Figure 4 contains the overall change rates and average assessments¹⁰ for special project, abusive transaction, and referral examinations for Fiscal Years 2006 through 2010.

**Figure 4: Change Rates and Assessments: Special Project,
Abusive Transaction, Referral Examinations (Fiscal Years 2006–2010)**

Fiscal Year	Special Projects	Abusive Transactions	Referrals	Average for Special Projects, Abusive Transactions, and Referrals
<i>Change Rate</i>				
2006	66.2%	81.3%	65.5%	67.0%
2007	49.9%	90.6%	73.2%	62.9%
2008	57.8%	85.0%	78.6%	70.2%
2009	62.3%	88.1%	83.8%	76.2%
2010	72.2%	89.8%	75.7%	80.4%
<i>Average Assessment¹¹</i>				
2006	\$1,045	\$20,971	\$1,754	\$2,791
2007	\$778	\$1,716	\$1,964	\$1,178
2008	\$1,102	\$13,741	\$140,575	\$1,891
2009	\$2,337	\$13,349	\$17,896	\$2,824
2010	\$1,991	\$18,064	\$24,235	\$3,462

Source: Audit Information Management System Reports for Fiscal Years 2006 to 2010.

⁹ The Form 5500 instructions outline plans that are not required to file Form 5500. These include governmental plans, certain church plans, and selected plans having only one participant.

¹⁰ While examinations are primarily geared toward determining whether retirement plans comply with the Internal Revenue Code provisions, assessments are another indicator of whether the Employee Plans function is identifying transactions or events that are not consistent with retirement plans' tax-exempt status.

¹¹ For Fiscal Years 2009 and 2010, we excluded 4 plans that had 17 large assessments, which exceeded \$2 million for each assessment. These 17 assessments accounted for 93 percent of the total for this 2-year period.



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Given the overall high change rates, examinations associated with special projects, abusive transactions, and referrals are identifying more compliance problems, providing better protection of taxpayers' retirement funds, and using Employee Plans function examination resources in an efficient and effective manner. Also, since projects can be the result of a number of factors including the type of plan and/or the issue involved, selection of work may cross market segments, which provides broader coverage for segments that may not have historically shown a high rate of noncompliance and thus may not be included if the risk-based approach were the only method being used.

Risk-based examinations

During Fiscal Year 2001, the Employee Plans function started a risk assessment approach to analyze its customer population by dividing its retirement plan population into market segments based on plan type and principal business activities. Between Fiscal Years 2002 and 2006, the Employee Plans function's market segment approach went through several modifications, including reducing the number of market segments, tracking and evaluating the extent of noncompliance as market-segment examinations were completed, and changing sampling methods to be more efficient.

Beginning in Fiscal Year 2006, the Employee Plans function refined the market-segment approach to direct resources to segments having the most noncompliance. To accomplish this, Employee Plans function management decided to stop working on any new market segments and concentrate on finishing market segments with examinations in process.

From that point forward, the only market-segment returns assigned to the Employee Plans examination staff were from segments, referred to as risk-based segments, determined to be highly noncompliant through baseline examinations.¹² In general, examiners are assigned cases from this category when there are either no cases from special projects, abusive transactions, and referrals remaining or when the examiners' skills do not match up with the skills required to perform higher priority examinations.

When summarizing the results of its initial market-segment approach, the processes that the Employee Plans function used included a sufficient number of examinations to conclude the results were reliable. In addition, the Employee Plans function used a sound process to validate its market-segment approach and ensure it identified productive sources for examinations. This process included completing its analysis of seven market-segments and posting detailed summaries to the "public" portion of its web site. Each summary included an overall assessment of compliance within the segment (e.g., high noncompliance) and a detailed description of any noncompliance noted during examinations. Also included were suggested actions that plan sponsors could take to avoid errors resulting in noncompliance. For these 7 segments, Employee

¹² Baseline examinations refer to the Employee Plans function's initial efforts to determine the percentage of a given market-segment's population that was noncompliant.



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Plans staff completed 7,175 examinations, of which 2,723 (38 percent) resulted in a change to the return.

As shown previously in Figure 3, these examinations resulted in a change to the tax return at a rate lower than the special project, abusive transaction, and referral examinations and the overall rate for Employee Plans function examinations as a whole. However, since Fiscal Year 2006 the Employee Plans function has improved its ability to identify noncompliance related to returns selected using a risk-based approach, as shown in Figure 5 below.

**Figure 5: Change Rates and Assessments: Risk-Based Examinations
(Fiscal Years 2006–2010)**

<i>Fiscal Year</i>	<i>Change Rate</i>	<i>Average Assessment</i>
2006	42.0%	\$1,247
2007	52.3%	\$367
2008	54.2%	\$1,205
2009	57.4%	\$2,225
2010	53.7%	\$1,088

*Source: Audit Information Management System
Reports for Fiscal Years 2006 to 2010.*

Prior to the above changes, the processes used to select specific types of plans for examination had historical change rates that were significantly lower. For example, staff from the Employee Plans function provided data for the historical change rate¹³ associated with specific risk-based segments. This information also included the results of examinations from the initial risk-assessment process completed during Fiscal Years 2004 to 2006 and from examinations completed as part of the risk-based targeted approach used starting in Fiscal Year 2006.

Figure 6 shows the evolution of the Employee Plans function's examination approach since the 1990s, as well as the improvement in the percentage of noncompliance detected for 10 risk-based segments, which accounted for nearly 70 percent of all closures since the inception of the market-segment approach. Almost all segments show a marked increase in noncompliance detected in the early years of the market segment approach compared to the 1990s. Most segments show an even greater percentage of noncompliance being detected since moving to the risk-based approach in Fiscal Year 2006.

¹³ Historical rate is based on information from the 1990s. This rate was computed by dividing the number of completed examinations that involved a change to the return by the total number of completed examinations.



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Figure 6: Comparison of Historical Change Rates for 10 Market Segments

Plan Type	Risk-Based Market Segment	Historical Change Rate (Overall for 1990s)	Risk Assessment Baseline Change Rate (Fiscal Years 2002–2004)	Risk-Based Examinations Change Rate (Fiscal Years 2006–2010)
401k	Professional, Scientific, Technical Services	21.0%	49.8%	44.1%
401k	Wholesale	22.1%	39.0%	44.3%
Profit Sharing	Wholesale	22.6%	33.9%	39.5%
401k	Health Care & Social Assistance	23.1%	33.6%	45.7%
401k	Finance & Insurance	20.2%	29.5%	40.6%
401k	Manufacturing	23.6%	35.3%	46.8%
401k	Construction	21.0%	41.1%	42.8%
Profit Sharing	Construction	22.8%	16.6%	43.0%
401k	Retail	22.8%	44.3%	55.7%
Profit Sharing	Manufacturing	24.2%	28.5%	42.0%

Source: Treasury Inspector General for Tax Administration analysis of Return Inventory and Classification System data.

Contributing to this improvement may be the use of a focused-examination approach adopted during Fiscal Year 2006. In the focused-examination approach, the emphasis is on evaluating the overall compliance level of the plan using a number of specific factors, including an assessment of the plan's system of internal controls. The intent of focused examinations is to take advantage of known areas of noncompliance by prioritizing several issues before the examination begins. These issues are selected based upon either historical data or other meaningful factors.

While having a lower change rate than special project, abusive transaction, and referral examinations, risk-based examinations protect taxpayers' retirement funds by providing examination coverage to areas that have been historically noncompliant. This will ensure resources are focused on high-priority areas each year.

Other types of examinations

The number of examinations selected for other reasons has increased due to the hiring of examiners needing experience with less complicated issues. As with many IRS functions, the Employee Plans function has hired new staff to conduct examinations. Training cases are assigned to newer staff as they complete formal classroom training.



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The volume of training cases more than tripled between Fiscal Years 2009 and 2010, accounting for over 8 percent of all completed Employee Plans function examinations in Fiscal Year 2010. These examinations provide a means for newer staff to begin working actual cases as part of developing their skills to complete more complex examinations in the future.

In addition, examiners from the Employee Plans function also assist staff from other operating divisions who discover potential compliance issues in the course of their duties. Examinations worked in conjunction with other IRS functions accounted for less than 1 percent of all Employee Plans function examination activity from Fiscal Years 2006 to 2010 and provide a means for ensuring that compliance issues, which may not otherwise be identified, are considered for examination. Figure 7 provides more detailed information.

**Figure 7: Training Cases and Examinations
Worked With Other IRS Functions (Fiscal Years 2006–2010)**

Fiscal Year	Training Cases			Cases Worked With Other IRS Functions		
	Total Closures	Percent of All Examinations	Change Rate	Total Closures	Percent of All Examinations	Change Rate
2006	552	7.2%	57.1%	62	0.8%	28.9%
2007	486	6.1%	71.6%	53	0.7%	50.9%
2008	399	5.4%	73.4%	15	0.2%	60.0%
2009	284	4.1%	77.5%	33	0.5%	42.4%
2010	893	8.3%	62.7%	24	0.2%	29.1%

Source: Audit Information Management System Reports for Fiscal Years 2006 to 2010.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether the Employee Plans function's processes for selecting examination cases allow for emerging issues to be considered and take into account the risk of noncompliance for the retirement plan universe. To accomplish this objective, we:

- I. Analyzed the Employee Plans function's market-segment and risk-based approaches to determine whether areas of noncompliance were effectively being identified.
 - A. Determined whether the results used to summarize each market segment and create the risk-based approach included sufficient information to conclude that the results of the risk analysis were reliable.
 - B. Determined whether processes for validating the market-segment and risk-based approaches were sufficient to ensure that the risk-assessment process was appropriately identifying productive sources of examinations.
 - C. Determined whether the Employee Plans function was sufficiently updating the market-segment and refining the risk-based approaches to be consistent with current trends in retirement plans.
 - D. Analyzed the results of risk-based examinations to ensure the market-segment and risk-based approaches are a useful tool for identifying areas of noncompliance and selecting returns for examination including:
 1. The percentage of examination workload.
 2. The percentage of closed examinations that resulted in a change to the return.
 3. The average amount of additional assessments for closed examinations.
 4. A comparison of risk-based examinations to other sources of examinations and assessing whether the source had been prioritized appropriately.
- II. Determined whether the Employee Plans function's processes ensured that retirement plans identified as a special project were being appropriately considered and evaluated for examination.
 - A. Determined whether the Employee Plans function was sufficiently identifying special projects to address the current retirement-plan universe, e.g., retirement plans that are not required to file Form 5500.



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- B. Determined whether the Employee Plans function was proactively acting on current economic and retirement plan issues by identifying issues as a special project.
 - C. Analyzed the results of special-project examinations to ensure those examinations are a useful tool for identifying areas of noncompliance and selecting returns for examination including:
 - 1. The percentage of examination workload.
 - 2. The percentage of closed examinations that resulted in a change to the return.
 - 3. The average amount of additional assessments for closed examinations.
- III. Determined whether the Employee Plans function's processes ensured that retirement plans identified by referral (including cases from the Employee Plans Compliance Unit) were being appropriately considered and evaluated for examination.
- A. Determined whether corrective actions taken as a result of one of our previous audits ensured that potentially productive referrals were being timely selected and examined.
 - B. Analyzed the results of the referral program to ensure it was a useful tool for identifying areas of noncompliance and selecting returns for examination including:
 - 1. The percentage of examination workload.
 - 2. The percentage of closed examinations that resulted in a change to the return.
 - 3. The average amount of additional assessments for closed examinations.
- IV. Determined whether the Employee Plans function was selecting workload for examination using methods other than the risk-based approach, special projects, abusive transactions, and referrals.
- A. Determined the volume of workload that was selected for examination by other sources.
 - B. Determined the reasons for using resources in this manner (e.g., training, insufficient workload for a geographic location, insufficient workload for a certain grade level, etc.).
 - C. Analyzed the results of selecting workload in this manner to ensure methods other than the risk-based approach are a useful tool for identifying areas of noncompliance and selecting returns for examination including:
 - 1. The percentage of examination workload.



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2. The percentage of closed examinations that resulted in a change to the return.
3. The average amount of additional assessments for closed examinations.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: the IRS Employee Plans function's policies, procedures, and practices for identifying and selecting retirement plans for examination to determine if they are in compliance with all applicable laws and regulations. We evaluated these controls by interviewing management, and reviewing examination results and data related to ongoing and completed examination activities. We also reviewed IRS data publications and Employee Plans function examination operation information. We relied on information accumulated by the IRS and the Employee Plans function in established reports and did not verify its accuracy.



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Appendix II

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Appendix III

Report Distribution List

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Appendix IV

Treasury Inspector General for Tax Administration Audits Related to the Employee Plans Function's Examination Selection Methods

Over the past 9 years, we have conducted many audits of the Employee Plans function's programs and processes. The following reports provide a chronology showing how the Employee Plans examination-selection methods have changed over time.

- **Fiscal Year 2002** – In Fiscal Year 2002, we first reviewed the Employee Plans function's methods for selecting examinations. At the time, we determined that not all examinations selected for audit were designed to focus on areas representing the greatest risk of noncompliance. In response, the Employee Plans function stated that it intended to develop a Risk-Assessment Program to ensure that returns selected for examination have a high probability of noncompliance.¹
- **Fiscal Year 2003** – We reviewed the Employee Plans function's progress and noted that it had implemented a Risk-Assessment Program that categorized plans into 20 industry segments and 11 plan types within each industry segment, for a total of 220 distinct market segments. We also determined the Risk-Assessment Program established priorities for selecting examinations in each of the market segments. However, validating data in all market segments would require a significant amount of time; therefore, we recommended a comprehensive, long-term plan to ensure resources are focused on the highest priority areas each year.²
- **Fiscal Year 2004** – We conducted a review of the Tax Exempt and Government Entities Division's abusive transaction program and determined that Division management had recently begun to develop a Division-wide program to address abusive transactions within its customer segments. We recommended the Tax Exempt and Government Entities Division develop some common processes to identify and reduce abusive transactions within its customer base. We also determined the Employee Plans function

¹ *Additional Improvements Will Better Focus the Employee Plans Function's Examinations Workplan on Areas That Identify and Correct Noncompliance* (Reference Number 2002-10-143, dated August 16, 2002).

² *Clarifying Goals and Refining Processes Would Improve the Employee Plans Risk Assessment Program* (Reference Number 2003-10-200, dated September 26, 2003).



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planned to establish a Compliance Unit in Fiscal Year 2005 to perform analysis to identify abusive scheme trends.³

- **Fiscal Year 2007** – We reviewed the Employee Plans function’s processing of referrals and determined that referrals were highly productive examinations. During the audit, the Employee Plans function changed its workload-selection methods to ensure referrals were distributed as part of the regular workload of Employee Plans Examination function groups, instead of being considered discretionary work.⁴
- **Fiscal Year 2010** – We identified retirement plan trends based on a wide range of statistical indicators. However, we were not able to provide information about retirement plans that are not required to file a Form 5500 such as churches and government agencies. We determined the number and types of plans had increased dramatically over the past 30 years. We also determined that the trends reflected in our report could dramatically change in the future given the instability in investments in recent years, the resulting impact on retirement plans, and legislative changes being considered by Congress.⁵

³ *The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development* (Reference Number 2004-10-190, dated September 29, 2004).

⁴ *Employee Plans Noncompliance Referrals Are Productive Sources of Work, but Processing Controls Need to Be Improved* (Reference Number 2007-10-185, dated September 24, 2007).

⁵ *Statistical Trends in Retirement Plans* (Reference Number 2010-10-097, dated August 9, 2010).