United States General Accounting Office

GAO

Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

July 1991

PENSION PLANS

IRS Needs to Strengthen Its Enforcement Program

GAO

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General Accounting Office
Washington, D.C. 20548

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Human Resources Division

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July 2, 1991

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This is our second report in response to your request that we evaluate the federal government's efforts to enforce the Employee Retirement Income Security Act of 1974 (ERISA). Our first report[1] concerned the number and types of enforcement activities conducted by the Department of Labor and Internal Revenue Service (IRS), the agencies primarily responsible for enforcing ERISA. This report focuses on the effectiveness of IRS's efforts to enforce ERISA's standards and expands on information we provided during our testimony before your Subcommittee.[2]

Results in Brief

IRS has increased the resources it devotes to examining pension plan operations, a key element of its ERISA enforcement strategy. But the IRS program has not been as effective as IRS expected in identifying plans with ERISA violations, for several reasons. IRS's criteria for targeting plans with a high potential for ERISA violations are outdated. Moreover, most plans examined in the past 3 years were selected to train inexperienced staff, rather than because the plan was likely to have a violation. Finally, IRS has not maintained an adequate oversight program to ensure that examinations were sufficiently thorough to identify ERISA violations.

IRS is taking action to address these issues. However, IRS intends to spend much of its enforcement resources on examining small, overfunded plans whose sponsoring employers may have received excessive tax deductions for plan contributions. While this initiative may raise significant revenues, it shifts IRS's limited enforcement resources away from examining plans where participants' benefits and the government's insurance program may be at risk.

Further, IRS may approve design changes to many plans without a detailed review to handle an anticipated large increase in approval

[1] Pension Plans: Labor and IRS Enforcement of the Employee Retirement Income Security Act (GAO/HRD-89-32, Jan. 23, 1989).

[2] Federal Government's Oversight of Pension and Welfare Funds (GAO/T-HRD-90-37, June 13, 1990).

requests resulting from the Tax Reform Act of 1986. This could diminish IRS's ability to ensure that plan designs comply with ERISA.

We are making several recommendations to the Commissioner of Internal Revenue to strengthen IRS's ERISA enforcement program. (See p. 12.)

Background

Currently, about 76 million Americans rely on private pension plans to ensure their financial security. ERISA established comprehensive standards to ensure that these employee benefit plans were free of mismanagement, fraud, and abuse, which can place plan assets at risk and threaten plan participants' benefits.

Participation standards establish requirements for how employees become eligible to participate in benefit plans. Vesting standards concern how a participant earns a nonforfeitable right to benefits. ERISA also required that defined benefit pension plans satisfy minimum funding standards to ensure that they have sufficient assets to pay promised benefits to retirees. IRS administers ERISA's participation, vesting, and funding provisions. The Department of Labor administers ERISA's reporting and disclosure provisions and fiduciary standards, which concern how plans are to be operated in the best interest of participants.

There are two types of pension plans. In a defined contribution plan, benefits are based on employer contributions to participant accounts plus investment earnings on the accounts. In a defined benefit plan, employers promise participants specified benefits that they prefund based on estimates of plan earnings and costs. Defined benefit plans can be overfunded or underfunded.

An underfunded defined benefit plan is one with unfunded liabilities; that is, the present value of its liabilities exceeds the value of its assets. This occurs, for example, when benefit improvements are granted covering past years of service or when actuarial assumptions are changed. Underfunding is not a violation of ERISA. ERISA's minimum funding standards require an annual contribution. The contribution amount generally includes a plan's estimated (1) cost for benefits earned during the current year and (2) amounts needed to amortize its unfunded liabilities over specified future periods.

In addition to standards, ERISA established an insurance program, administered by the Pension Benefit Guaranty Corporation (PBGC), to protect participants in defined benefit plans. PBGC guarantees, within certain limits, participants' earned benefits at plan termination if plan assets are not sufficient to cover guaranteed benefits. The government's potential exposure to underfunding in pension plans it insures is large—PBGC estimated its potential exposure in specific large plans to be $20 to 30 billion.

IRS's ERISA Enforcement Program

Within IRS, the Assistant Commissioner for Employee Plans and Exempt Organizations is responsible for ensuring that about 900,000 pension plans comply with ERISA. Under the Assistant Commissioner, the Employee Plans Division directs the activities of about 1,000 revenue agents assigned to ERISA enforcement activities at seven IRS district offices nationwide.

IRS's mission is to achieve "the highest degree of voluntary compliance" with federal tax laws and regulations. IRS accomplishes this principally by (1) reviewing and approving plan designs and (2) examining pension plan operations and tax returns to ensure that they comply with tax laws and regulations.

Plan administrators generally ask IRS to review and approve a plan's design when it is started, amended, or terminated. IRS reviews plan documents to determine that the design complies with ERISA and, thus, qualifies for favorable tax treatment.[3] IRS tries to rule on these requests within 270 days. ERISA provides that a plan sponsor, administrator, or participant can petition the U.S. Tax Court for a declaratory judgment concerning the plan's qualification if IRS fails to rule within that time.

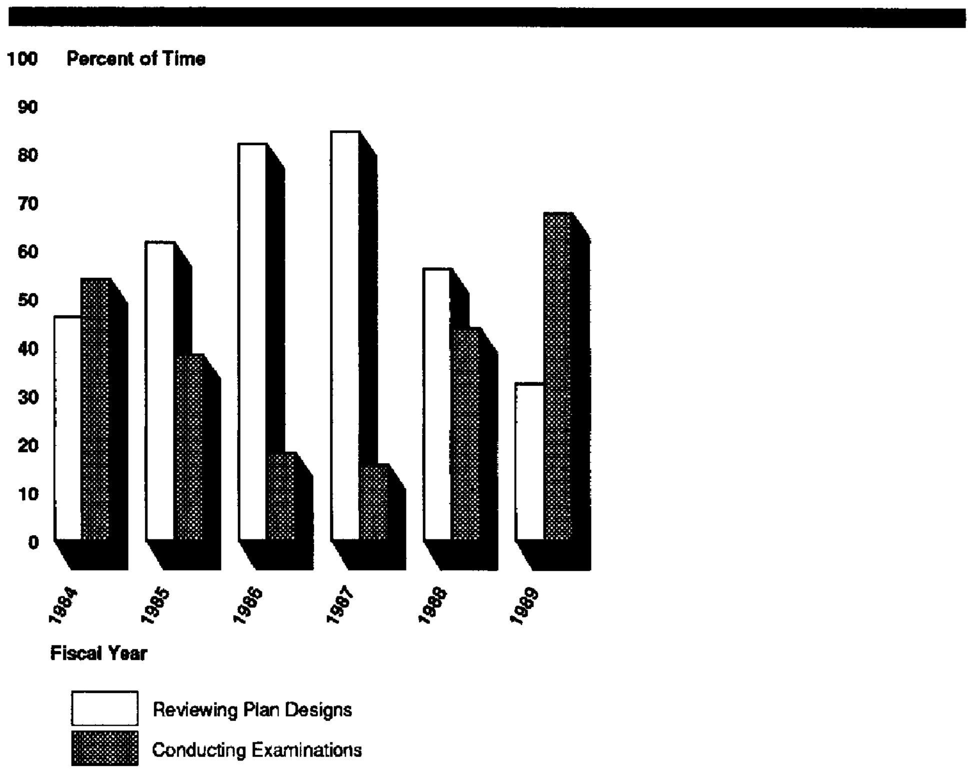
Examinations determine whether plan operations comply with ERISA. These examinations involve identifying plans with a high potential for ERISA violations, reviewing plan activities to determine compliance, collecting excise taxes resulting from violations, and recommending changes in corporate and individual tax returns.

In recent years, most of IRS's ERISA enforcement resources have been spent reviewing and approving plan designs, rather than examining plan

[3]This means that employer contributions to pension plans are tax deductible, earnings on the pension plan assets are not taxed, and employees do not pay taxes on their benefits until they are received.

operations (see fig. 1). This emphasis on plan design reviews was necessary because frequent changes in ERISA required companies to repeatedly amend their pension plans.

Figure 1: Allocation of IRS's ERISA Resources Between Enforcement Activities



Between 1980 and 1986, examinations of plan activities ranged from about 28,000 to about 18,000. When examinations fell to about 5,000 in 1987, IRS decided that the number of plans examined was too low to ensure a high degree of voluntary compliance with ERISA.

In fiscal year 1988, IRS implemented a plan to strengthen voluntary compliance by reallocating resources to help ensure a balanced enforcement effort. The plan provided that 55 percent of staff resources spent on employee plans would be targeted to examining plan activities and 45 percent to reviewing plan designs.

Objective, Scope, and Methodology

You requested that we evaluate the effectiveness of IRS's ERISA enforcement program, focusing on recent changes that shifted resources from reviewing plan designs to examining plan activities. To accomplish this objective, we reviewed ERISA policies and procedures at IRS's national office in Washington, D.C., and discussed them with IRS officials. We also examined statistics on IRS enforcement activities for fiscal years 1985-89.

To determine how these policies were implemented and evaluate their impact, we visited IRS district offices in Cincinnati, Dallas, and Los Angeles. We selected these offices for several reasons. The Cincinnati office reported the highest percentage of examinations that identified ERISA violations. The Los Angeles office performed the largest number of plan design reviews and examinations. The Dallas office had characteristics typical of other district offices.

At each of these offices, we reviewed implementation of IRS policies and procedures for reviewing plan designs and examining plan activities and discussed them with pertinent IRS officials. We also reviewed relevant statistical reports and correspondence. Our work was performed between June 1989 and June 1990 in accordance with generally accepted government auditing standards.

IRS Needs to Improve Its Examination Selection Procedures

Examining pension plan activities is an essential element of IRS's ERISA enforcement program. However, IRS's examination program has not been as effective as expected in identifying pension plans with ERISA violations. IRS intends to develop a new examination selection system to better target plans with ERISA violations. We believe the new system should focus on violations in underfunded defined benefit plans because they pose a risk to both participants and the government.

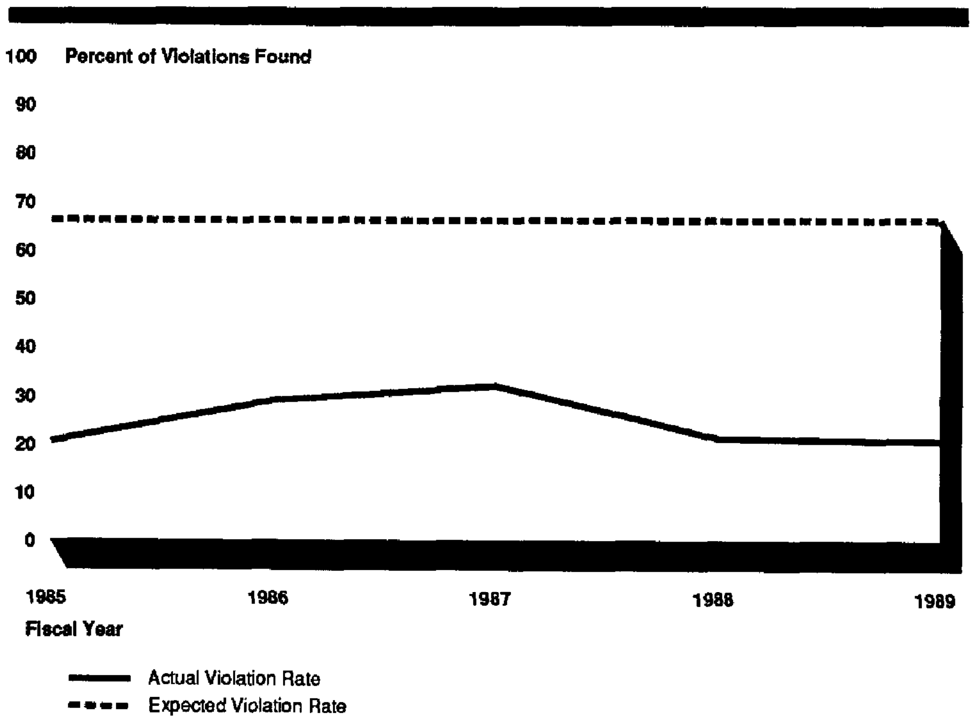
Most Examinations Have Not Identified Violations

IRS uses its taxpayer compliance measurement program (TCMP) to evaluate the effectiveness of its enforcement efforts and develop criteria for targeting plans. One TCMP has been conducted for employee plans. It involved examinations of almost 18,000 randomly selected pension plan returns for plan year 1978. The results of the examinations, conducted during 1980 and 1981, showed that about 32 percent of the plans examined required some change in their design or operation to comply with ERISA.[4]

IRS used the TCMP results to develop a profile of plans most likely to have an ERISA violation, so it could target its enforcement resources. Formulas are used to assign a score to each plan return. The higher the score, the higher the potential for a violation. In its report, IRS said it expected that using these formulas to select plans would result in finding violations in about 66 percent of all examinations.

According to IRS statistics, in each year since 1985 fewer than 32 percent of its examinations identified ERISA violations or less than half what IRS expected to identify using the selection criteria developed from the TCMP. As shown in figure 2, the actual violation rate ranged from 32 percent in 1987, when only about 5,000 examinations were performed, to 20.6 percent in 1989, when a 5-year high of 32,500 examinations were conducted.

Figure 2: Comparison of IRS's Expected and Actual Violation Rates



[4]Taxpayer Compliance Measurement Program: Phase VIII, Cycle 1, Employee Plan Returns, IRS, September 1983.

IRS field staff attributed the low violation rate to using outdated targeting criteria. Employee plan officials in IRS's national office agreed that the selection criteria were outdated because they were based on plan characteristics that had changed since the formulas were developed from the TCMP for plan year 1978.

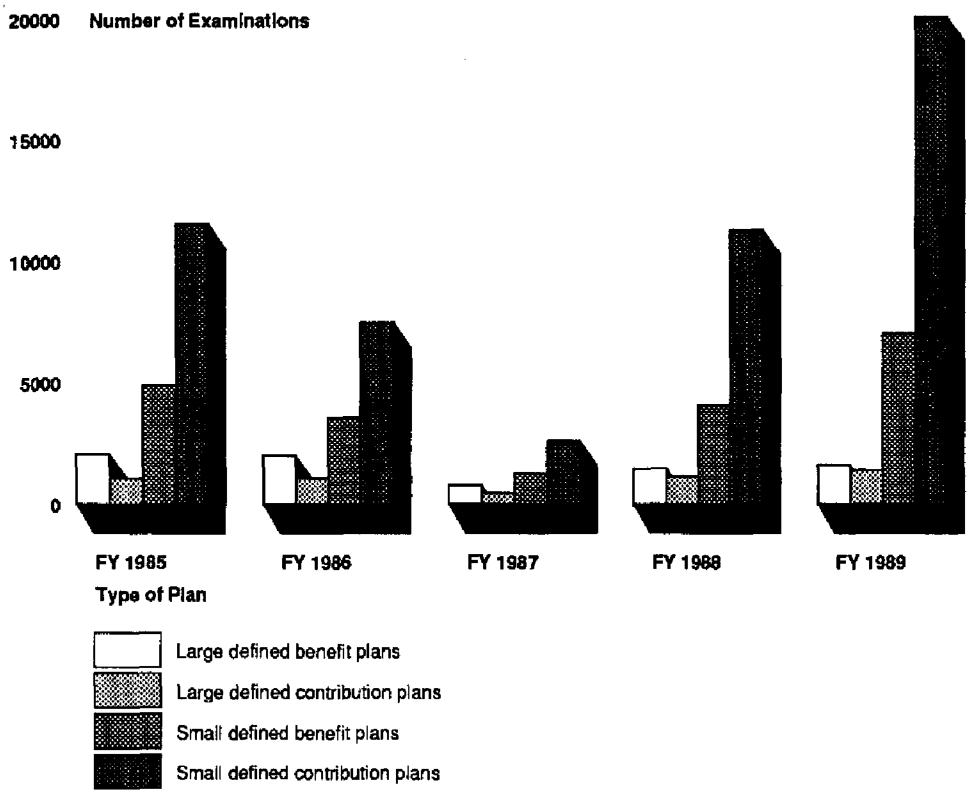
Examination Resources Focused on Training Inexperienced Agents

Another factor that may have contributed to the low violation rate found by IRS is that many plans examined in the last 3 years were chosen to train inexperienced agents, rather than because they had a high potential for ERISA violations. IRS officials at two of the three district offices we visited told us that due to high turnover, they had hired many new agents in recent years. Because of the large number of requests for plan design reviews that IRS received from 1985 to 1987, the new agents worked on such reviews for several years before they were trained to do examinations.

In fiscal year 1988, IRS began to transfer agents from reviewing plan designs to doing examinations. To train these inexperienced agents in performing examinations, IRS district offices selected small, less complex plans—usually defined contribution plans—for them to examine, rather than choosing plans based on their potential for violating ERISA. IRS field staff told us that these plans provided the agents with the best training because they were easier to examine.

Our analysis of how IRS examination resources have been spent over the past 5 fiscal years showed that most were allocated to examining defined contribution plans. As shown in figure 3, the number of small defined contribution plans examined exceeded other plan examinations in each year.

Figure 3: Distribution of Examinations by Plan Type and Size



Note: Large plans have 100 or more participants and small plans have fewer than 100 participants.

New Examination Selection Procedures Being Developed

IRS is testing an alternative examination selection system. IRS hopes the new system will correct several problems and enable IRS to target plans with ERISA violations more quickly and accurately.

The current selection system has several flaws. The formulas developed from the TCMP are outdated, and conducting a new TCMP to update them would be costly and take about 5 years. In addition to using the formulas, IRS often selects plans based on single characteristics, such as type of plan or number of participants. But this method does not allow IRS to select a plan with a combination of characteristics that suggest an ERISA violation.

The formulas IRS used to select plans for examination did not consider a plan's funded status. A violation in an underfunded plan poses a greater risk to its participants and the government's insurance program than a violation in an overfunded plan if the underfunded plan terminates.

The new system will enable IRS to select plans with multiple characteristics that suggest a high potential for ERISA violations. In addition, the new criteria can be periodically revised without having to wait for the results of another TCMP. The new system was not developed at the time of our review, and we could not determine the extent to which it would consider plans' funded status.

IRS also intends to examine a number of defined benefit plans during the next few years as part of a special revenue initiative focused on overfunded plans with one to five participants. For fiscal year 1991, IRS expects that about 17 percent of all its examinations will be such plans. This initiative is expected to produce up to $800 million in tax revenue through 1993 by disallowing plan sponsors' tax deductions for plan contributions that IRS believes exceeded ERISA's funding limitations.

IRS Needs to Review More Examinations to Ensure Their Quality

To effectively enforce ERISA, IRS needs to ensure that its examinations are sufficiently thorough to identify violations. In the last few years, IRS has not reviewed these examinations to determine that they met agency standards. IRS implemented a new quality assurance program for employee plan examinations in February 1990. However, the program does not provide for reviewing enough examinations to draw statistically valid conclusions about the quality of a district office's examination program.

IRS has long recognized the need for independent assessments of its district office operations. As part of this oversight process, IRS's national and regional offices historically have reviewed district office operations to determine whether enforcement programs were effective and examinations met IRS's quality standards.

At two of the three district offices we visited, neither the national nor the regional office had reviewed any examinations from 1987 through 1989. At the other office, only 29 examinations had been reviewed. IRS officials said that the oversight program had been curtailed because of (1) reductions in the regional office staff who oversee district operations and (2) travel fund reductions, which limited visits to district offices.

In February 1990, IRS initiated a new quality assurance program that will review each district office's employee plan operations every

2 years. The program includes a review of a judgmentally selected sample of between 50 and 75 completed examinations to determine whether they meet IRS's standards. IRS officials told us that the sample size was based on the number of examinations the assessment staff could review during a 1-week visit.

This sample may not be sufficient to statistically evaluate the quality of the district office's examinations. An effective judgment sample requires some knowledge about the types of examinations where quality problems are likely to exist. Because IRS has not reviewed examination quality for several years, it does not have any recent information on the types of examinations that are likely to have quality problems. IRS could improve its quality assurance program by reviewing a random sample of all examinations a district office closed since the last review. The results, unlike those of a judgmentally selected sample, could be projected to all examinations. This would enable IRS to determine the extent of problems in a district office's examination program.

We used a computerized statistical program to calculate the number of completed examinations IRS would have to sample in order to achieve an acceptably precise estimate of examination quality. Based on the number of examinations each district office closed during the past 2 years, we determined that a review of about 95 randomly selected examinations at each office would permit an acceptably precise estimate of the number of examinations that failed to meet IRS's quality standards. That is, IRS could project the sample results to all examinations at a 95-percent confidence interval with a 10-percent margin for error.

IRS Needs to Evaluate Changes in Plan Design Review Program

In fiscal year 1991, IRS expects to receive requests from over 250,000 pension plans to approve applications, terminations, and design changes. This is about 2.4 times the work load expected for fiscal year 1990. The large increase is due to anticipated requests to approve plan design changes made to comply with the Tax Reform Act of 1986. To meet this demand and still spend most ERISA enforcement resources on examinations, IRS made several changes to reduce the time spent reviewing plan designs. However, these actions may not save as much time as IRS expects. As a result, IRS may have to shift agents from conducting examinations to reviewing plan designs, as it has in similar past circumstances, or approve the designs of many plans without ensuring that they comply with ERISA's participant protections.

IRS expects to approve up to 75 percent of plan designs without submitting them to an agent for a detailed review. This is a significantly higher rate than the previous high of 47 percent. Most will be plans with standardized provisions, IRS believes. IRS has a number of programs that encourage the adoption of standardized provisions.

Its master and prototype program permits institutional sponsors, such as banks, to market plans approved by IRS's national office to employers. Adopters of most of these plans do not apply to district offices. Others submit selected plan features to the district offices for streamlined review. IRS estimated that 40 percent of the plans adopted by all employers after the 1984 amendments were derivatives of plans approved under the national master and prototype program.

IRS also has "volume submitter" programs. In these programs, pension plan practitioners, typically lawyers and employee benefit consulting firms, develop standard plan designs and submit them to IRS's district offices for approval. The practitioners then sell them to employers. Because IRS has already approved the standardized provisions, they need not be reviewed when an individual plan is submitted to IRS. In addition, IRS has instituted a regional prototype program, which makes the features of the master and prototype program available to practitioners.

For nonstandardized plans that meet certain criteria, IRS intends to approve plan designs without reviewing the plan language for compliance with ERISA. These include small plans and plans being terminated without any excess assets being returned to the sponsoring employer.

If IRS's expectations for high participation in its volume submitter programs are not realized, it will have to either shift enforcement resources from conducting examinations or approve many design changes without a detailed review. Either step could adversely affect IRS's enforcement program.

Shifting resources to review plan designs could create a condition similar to 1987, when examinations fell to a level that IRS acknowledged was too low to ensure that plans were operating in compliance with ERISA. IRS officials also recognize that approving plan designs without a detailed review could result in approving designs that do not comply with ERISA.

IRS officials do not know what impact, if any, the changes they have made in plan design reviews will have on voluntary compliance with ERISA. Further, they have no strategy for assessing any such impact.

Conclusions and Recommendations

IRS has taken steps to enhance the effectiveness of its ERISA enforcement program. Increasing the emphasis on examinations, working on new approaches for targeting potential violators, and initiating a new quality assurance program should, if properly implemented, improve the security of participants' benefits.

However, additional actions are needed to ensure that IRS's ERISA enforcement program better protects the interests of the government and participants. Although IRS's special emphasis on small, overfunded defined benefit plans is expected to produce significant revenues, using resources for this effort limits those available to examine plans that may become liabilities of PBGC.

IRS's new targeting system should use selection criteria that include funding status for defined benefit plans. That is because plans that are or may become underfunded pose a higher risk to participants and the government. Also, IRS should randomly select an expanded number of examinations for review in its quality assurance program so it can draw statistically valid conclusions about their quality. Further, because IRS considers the review of plan designs to be an important element of its enforcement program, it should develop a strategy for evaluating the impact of the changes it has made to reduce the time spent on reviewing plans. It is especially important to determine the extent to which large numbers of nonstandardized plans approved without detailed review comply with ERISA.

We recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Employee Plans and Exempt Organizations) to

- include plan underfunding among the criteria for targeting plans for examination,
- revise quality assurance procedures so that enough examinations are reviewed to draw statistically valid conclusions about examination quality, and
- develop a strategy to determine whether approving nonstandardized plans without detailed review adversely affects plan participants and compliance with ERISA.

Agency Comments and Our Evaluation

We obtained written comments from IRS. In a letter dated December 28, 1990 (see app. I), IRS agreed with our recommendations to improve its examination selection criteria and review more examinations to ensure their quality. However, IRS did not agree with our recommendation that it evaluate changes in its plan design review program.

IRS Needs to Improve Its Examination Selection Procedures

IRS agreed that it needs to improve its examination selection criteria. It noted that its new examination targeting system will address funding deficiencies. IRS also plans to use the recently hired actuaries in its district offices to examine plans that change funding method—a potential area for abuse of the funding rules.

IRS said it has had programs in place for many years that targeted plans with funding deficiencies. To support its contention it described some of its efforts concerning plans that do not meet ERISA's minimum funding standards. In a later meeting with us, IRS officials also identified specific plan characteristics that could be used to target plans that may be underfunded.

We agree that IRS has targeted plans with large minimum funding violations for examination and reviewed the funded status of plans seeking waivers from large plan contributions needed to comply with ERISA's minimum funding requirements. However, as IRS points out in its comments, plans that meet minimum funding requirements can be underfunded. While the characteristics that IRS identified could be used to target underfunded plans, neither IRS's program plans nor the work plans for the three district offices we visited identified underfunded plans as an area that should be targeted.

Further, IRS officials told us that there was no reason for them to examine underfunded plans because there was no prohibition against a plan being underfunded. They said that IRS should not be examining underfunded plans because they were not good indicators of plans with ERISA violations and were a poor use of IRS's examination resources.

We are not suggesting that underfunding violates ERISA or is indicative of violations. However, plans that are underfunded pose a greater risk to the government than those that are not. Therefore, we believe that underfunding should be among the criteria used for targeting plans.

Regarding our statement that IRS examined mostly small defined contribution plans, IRS stated that there are about three times as many defined contribution plans as defined benefit plans, and it had examined a slightly higher percentage of defined benefit plans than defined contribution plans in 1989. We see no reason why similar percentages of plans should be selected from each group. Our point is that the defined contribution plans, which do not pose a risk to the government's insurance program, were often selected for training purposes, rather than the plans' potential for violating ERISA.

IRS Needs to Evaluate Changes in Plan Design Review Program

IRS did not agree with our recommendation that it develop a strategy to determine whether changes in the plan design review program adversely affect plan participants and compliance with ERISA. IRS also provided additional information on its programs related to standardized plans, which were not specifically discussed in our draft report. We have added data on these programs to the report.

IRS said that after the 1984 tax law amendments, it approved over 25,000 master or prototype plans and estimated that 40 percent of plans adopted by all employers were derivatives of these plans. IRS says it has taken actions that it hopes will expand the program. IRS said that, as of November 30, 1990, at least 17,970 plans will participate in its regional prototype program and at least another 30,990 in district office volume submitter programs. IRS officials are optimistic that their actions to make the programs more attractive to plan sponsors and the complexity of tax laws will improve the participation rate. In addition, IRS officials believes that, because changes in law have reduced the tax benefits available through pension plans, there will be an overall decrease in requests for plan design reviews. IRS notes, however, that if necessary, resources devoted to examinations will be used to review plan designs.

IRS stated that, contrary to our draft report, it has procedures to evaluate the impact of changes in the plan design review program. The procedures include (1) reviews of specimen plans[5] for volume submitter participants, (2) reviews by the national office of the first 10 cases for each district office, and (3) postreviews by the national office of selected cases.

We continue to believe that the changes in IRS's plan design review program should be evaluated. Even if there is high participation in the

[5]Initial submissions of the basic plan document.

volume submitter programs, nonstandardized plans will not be eliminated. In our view, the procedures described by IRS do not provide sufficient assurance that approving nonstandardized plans without reviewing the plans' provisions does not adversely affect compliance with ERISA. Reviewing specimen plans does not provide information on plans with nonstandardized provisions. Further, reviewing the first 10 cases from each district office when the determination work load is light may not provide an accurate assessment of the impact of IRS's screen-out criteria when the large influx of determinations begins, especially if additional staff with less experience with determinations have to be assigned. Finally, the head of IRS's determination branch for employee plans told us that IRS's postreview process for plan design reviews has been suspended since March 1988. No date has been set for restarting the program, and there is no guidance on how many cases will be evaluated or how the postreview program will be conducted.

As arranged 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 other congressional committees with jurisdiction over ERISA and IRS, the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. Copies will also be made available to others on request.

If you have any questions or would like additional information, please call me on (202) 275-6193. Other major contributors to this report are listed in appendix II.

Sincerely yours,

Gregory J. McDonald
Associate Director,
Income Security Issues

Comments From the Internal Revenue Service

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

COMMISSIONER

DEC 28 1990

Joseph F. Delfico
Director, Income Security Issues
Human Resources Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Delfico:

We have reviewed your draft report entitled PENSION PLANS: IRS Needs to Strengthen Its Enforcement Program.

Of your three recommendations, we agree with your assessments that the Service needs to improve its examination selection criteria in the employee benefit plan area, and that we need to review more examinations to ensure their quality. We are planning to implement these changes during 1991. However, we believe that your third recommendation that the Service needs to evaluate changes in our plan design review program is based on incomplete information. We have included specific comments and additional information on your recommendation in the enclosure.

Thank you for the opportunity to comment on this report and to provide information that you may not have acquired during your reviews. We ask that this information be considered in your final report.

Best regards.

Sincerely,

Fred T. Goldberg, Jr.

Enclosure

IRS COMMENTS ON RECOMMENDATIONS
CONTAINED IN GAO DRAFT REPORT ENTITLED
"PENSION PLANS: IRS NEEDS TO STRENGTHEN ITS ENFORCEMENT PROGRAM"

RECOMMENDATION TO IRS

We recommend that the Commissioner of Internal Revenue direct the Assistant Commissioner (Employee Plans and Exempt Organizations) to:

Recommendation: Include plans that are or may become underfunded among the criteria for targeting plans for examination.

Comment:

As you noted in your report, we are developing a new examination targeting system, the Return Inventory and Classification System. The first phase of this system, which will be in place in 1991, will allow:

- Quick, systematic testing and development of new examination programs.

- More efficient targeting of plans meeting the criteria proven in our testing to indicate a high probability of compliance problems.

Phase two of our implementation will allow:

- Data on returns filed to be reviewed by our agents on computer screens without waiting for the returns to be retrieved from central files.

Although we will include programs in this new system that address plans with funding deficiencies, we also feel that we have had such programs in place for many years. Underfunding in itself is not always an indicator of a compliance problem.

First, as we have testified before the Subcommittee on Oversight and Social Security of the House Committee on Ways and Means in 1986 at hearings on Pension Plan Underfunding, a pension plan may meet the minimum funding standards of section 412 of the Code and still be considered "underfunded" in the sense that the value of plan assets is less than the present value of accrued benefits under the plan which, for large plans, could include substantial past service costs. The plan will then have an unfunded current liability while the plan still satisfies the minimum funding requirements. Consistent with sound pension

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policy, current law does not require that a plan never be in an underfunded status (reflecting an unfunded liability.) This would deter the formation of defined benefit plans with past service costs reflected in such a liability. The minimum funding standards permit an employer to amortize the costs of providing past service benefits over thirty years. In setting these rules, Congress recognized the need to avoid making the costs of providing benefits on account of past service prohibitively expensive.

Second, since 1983 our return selection criteria have automatically targeted all plans with reported funding deficiencies greater than $10,000. We have consistently considered underfunding in our examination program.

Third, we also have the responsibility under ERISA to administer the process under which employers in needy circumstances may seek waivers of their required contributions. In the larger cases, where the amount of the waiver sought exceeds $1,000,000, we coordinate automatically with the Pension Benefit Guaranty Corporation(PBGC) in deciding whether to grant such waivers and as to whether security must be provided for any amounts that are waived. In cases of this size where the plan is underfunded, waivers are granted only when full security that is satisfactory to the PBGC is provided to the plan. This cooperative oversight by the agencies provides the legislated measure of security over plan assets envisioned by Congress in enacting the ERISA standards.

Fourth, in fiscal year 1990, to increase our ability to review actuarial issues in plan examinations, we authorized our field offices to hire actuaries. These individuals are now in place in each key district, consulting regularly with National Office staff and providing invaluable onsite expertise. With the help of these actuaries, a pilot examination program of the type we have initiated in other areas is currently being planned. The Service will examine returns of plans indicating a change in funding method which can potentially be an area for abuses of the funding rules. The results of this program will yield indicators of compliance in this area and be factored into future examination criteria.

Finally, you have made your recommendation from the premise that we intend to spend much of our enforcement resources on examining small, overfunded plans whose sponsoring employers may have received excessive tax deductions for plan contributions. We plan to examine a total of 14,000 plans under this program from fiscal years 1990 through 1992. During that period we will conduct over 110,000 examinations of employee benefit plans. This program represents only 17% of planned examinations for fiscal year 1991, not 45% as identified in the draft report. It is imperative that the Service act forcefully when it has clear

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evidence of abuse, especially when the statute of limitations is expiring on plans that employ techniques that the law does not allow. To your finding that our examination resources over the past five fiscal years have been allocated primarily to examining defined contribution plans, we would like to point out that the defined contribution plan population is over three times larger than that of defined benefit plans. In 1989, our examination coverage rate for defined benefit plans was over 4% while the coverage rate for defined contribution plans was 3.5%.

> Recommendation: Revise quality assurance procedures so that sufficient examinations are reviewed to draw statistically valid conclusions about examination quality.

Comment:

We concur in your second recommendation that we improve our quality assurance program by increasing our planned reviews to cover a random sample of examinations closed per district since our last review. The changes will be incorporated into our quality assurance procedures during 1991.

> Recommendation: Develop a strategy to determine whether changes in the plan design review program adversely affect plan participants and compliance with ERISA.

Comment:

Your draft report concludes that determination receipts under our various volume submitter programs will fall short of our projections, requiring a shift of resources away from examinations to review plan designs or the approval of design changes without a detailed review. We would like to provide information in support of our estimates and to advise you of our strategies to manage these programs taking into account other factors such as the timing of the issuance of regulations which impact on the determination process.

The draft report neglects to mention our National Office Master and Prototype program which has existed since 1962 and serves as a mainstay in the pension plan area. This program and others have evolved into an umbrella of volume processing methods to ease burdens on both taxpayers and the Service.

The master and prototype program permits institutional sponsors such as banks, insurance companies and brokerage houses to market plans reviewed and approved in the National Office to thousands of employers. Customers of these institutions then adopt the preapproved document. Adopters of most so-called "standardized" plans do not apply to the districts at all; others submit selected plan features to the district office for streamlined review. After the 1984 amendments, we approved over

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25,000 master or prototype plans and we estimate that 40% of plans adopted by all employers were derivatives of these plans. In an effort to expand the program for the Tax Reform changes, we have held a series of meetings with plan sponsors. At their suggestion, we have incorporated two new features into the program. First, we have enhanced the variety and flexibility of investment opportunities available to employers adopting master and prototype plans. This was seen by sponsors as their prime marketing need. Second, we have an extended reliance period which enables sponsors filing in 1989 or 1990 to rely on notification letters through 1994, thereby avoiding continued resubmissions.

Also at the request of practitioner groups such as the ABA and the AICPA, we have instituted the Regional Prototype program, which makes the features of the Master and Prototype program available to practitioners. As of November 30, 1990, we have received 599 of these plans, each representing at least 30 potential adopters or 17,970 plans. Under the well established volume submitter programs in each district (for other practitioner specimen plans) receipts to date total 1,033 plans representing another 30,990 adopters. These figures are conservative estimates. One of the document preparation firms that is responsible for over 20% of the determination submissions we receive, has indicated that the vast majority of its clients will move to these Regional Prototype plans or to a Volume Submitter plan.

Your draft report expressed the concern that we will not know what impact our changes for reviewing plan designs will have on voluntary compliance, nor do we have any strategy for assessing it. On the contrary, when the TRA '86 program began, all specimen plans were subject to mandatory review and the first ten cases per district came to the National Office for pre-contact review. Only when the review staffs were assured that the quality of review was high, were the streamlined review procedures fully implemented. As we have done for many years, we will use National Office post review of cases fully reviewed and those technically screened to assure that only the areas of lowest risk are subject to technical screening.

Since the last major opening of the determination program, user fees have been instituted. The fee structure is heavily weighted in favor of plans adopting a plan approved under one of our volume programs. ($125 versus $700-$825 for an individually designed plan.)

We would also like to note that changes in tax law since the last opening have made ERISA plans less appealing since the benefits available through the use of such plans have been scaled back considerably. This will result in a decrease in the overall

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volume of determination letter applications. In addition, the complexity of the law makes the "safe harbors" available in standardized plans much more appealing to adopters of plans.

While we cannot predict with certainty that 75% of the determination letter workload will be derivatives of pre-approved plans, we are doing everything we can to anticipate any shortfall. Recently, the filing period was extended through 1992 to even out the workload. At this point, while the workflow is still moderate, we are working with our field offices to resolve the most difficult technical issues. This will enable our technical screening procedures to handle the full force of determination receipts when it materializes. We have, of course, prepared contingency plans if our estimates of standardized plan adopters are not realized. We fully expect to maintain our plan of devoting 55% of our technical resources to the examination program. In fact, we expect to exceed this ratio again in fiscal year 1991 as we did in fiscal year 1990 when the actual ratio was 73% examinations to 27% determinations. If, as has occurred in the past, we need additional resources to meet the demands of determination receipts, we will adjust our examination to determination resource ratio on a district-by-district basis.

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