United States General Accounting Office

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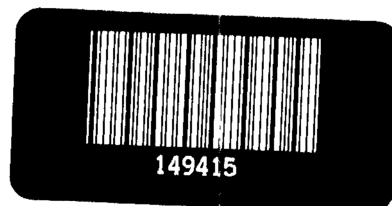
Report to Congressional Committees

June 1993

SMALL PENSION PLANS

Concerns About the IRS Actuarial Audit Program



GAO

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

Human Resources Division

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June 30, 1993

The Honorable Robert C. Byrd
Chairman, Committee on Appropriations
United States Senate

The Honorable William H. Natcher
Chairman, Committee on Appropriations
House of Representatives

In 1989, the Internal Revenue Service (IRS) initiated a national program to audit small defined benefit pension plans (those with one to five participants). This occurred subsequent to an IRS review that indicated some highly paid professionals were obtaining large tax deductions by making extremely large contributions to their pension plans. IRS concluded that in many cases large tax deductions were being taken based on unreasonably conservative actuarial assumptions used in calculating allowable pension contributions. Many taxpayers and their actuarial or legal representatives complained that IRS's actions were mainly an attempt to generate federal revenues aimed predominately at small businesses.

In response to this controversy, the Congress required that we analyze the impact of the IRS program on small business sponsors of defined benefit pension plans.[1] In subsequent discussions with your offices, we agreed to examine the validity of the complaints concerning why IRS undertook the program, whom the program targeted, and whether IRS considered taxpayer facts and circumstances before substituting its own actuarial assumptions.

The methodology used in conducting our study is discussed in appendix I.

Background

IRS and the Department of Labor are responsible for enforcing the Employee Retirement Income Security Act (ERISA) of 1974. IRS enforces ERISA vesting, participation, and funding provisions in defined benefit pension plans by reviewing proposed plan designs and examining plan returns for compliance with tax laws. The Department of Labor administers ERISA reporting and disclosure provisions and fiduciary standards, which concern how plans should operate in the best interest of plan participants.

[1]See the conference report, H.R. Rep. No. 234, 102nd Congress, 1st Session (1991), that accompanies H.R. 2622, 102nd Congress, 1st Session (1991).

In a defined benefit plan, employers promise participants specified benefits that are to be funded over a period of time based on estimates of plan earnings and costs. Annual contributions to such plans are tax deductible and are based on such actuarial assumptions as the rate of return on plan investments before and after retirement and the participants' expected retirement ages. The lower the assumed interest rates and the younger the assumed retirement age, all other factors being equal, the higher the allowable annual contributions to a plan.

ERISA requires that the assumptions be certified by actuaries enrolled by the Joint Board for the Enrollment of Actuaries. The Internal Revenue Code limits the amounts that can be deducted annually and provides that actuarial assumptions must be reasonable, but neither the code nor IRS guidelines is very specific as to what constitutes reasonable assumptions. IRS adopts audit criteria for reviewing returns and for determining compliance with the code. These criteria, called safe harbors, serve as a guideline for determining reasonable actuarial assumptions.

The special IRS program to audit contributions to small defined benefit plans began as a pilot project in 1984, expanded nationwide in 1989, and ended in July 1992. Final settlement of cases involving proposed tax deficiencies and penalties has continued past the program's ending date because of taxpayer appeals. In all, IRS examined 15,646 returns representing an estimated 7,800 small defined benefit plans for the tax years 1986, 1987, and 1988 (see app. II). IRS originally concentrated on returns where the annual pension plan contribution per participant was more than $100,000, but the agency later examined returns with pension plan contributions below that threshold. IRS also estimated there were more than 100,000 defined benefit plans with one to five participants filing returns in the years for which the plans were reviewed under the audit program.

Results in Brief

IRS was appropriately pursuing its ongoing mission to monitor compliance with the Code when it expanded the small defined benefit pension plan audit program in 1989. However, the program was not well planned or implemented and, thus, generated objections from plan sponsors and the actuarial community. IRS admittedly underestimated the complexity of the issues, including the legal support for its positions, and overestimated the extent of excessive deductions.

The legitimate concerns of actuaries and their taxpayer clients, such as the applicability of IRS's 1984 actuarial audit guidelines, and the widespread practice in the actuarial community of using more conservative assumptions for funding small plans than for large plans, were not adequately anticipated and addressed. While IRS said the program was aimed at increasing taxpayer compliance through correction of abuses, and we concur that this was its intended focus, the agency sent a different message to the actuarial community by designating the program as a special revenue initiative.

In general, the actuarial community's complaints about IRS's intent and the program's focus were not well supported on the basis of our review. For example, we found no evidence that IRS singled out traditional family-owned small business owners for examination. Rather, IRS targeted small plans with large pension deductions whose principal participant was usually a highly paid professional. IRS did not rigidly impose its safe harbor actuarial assumptions, but considered the taxpayer's facts and circumstances in each case.

Finally, we believe that recent and future court decisions may provide a basis for resolving many pending appeals and will likely have a far-reaching impact on the future independence of actuaries in determining pension plan funding assumptions. While IRS should continue its efforts to foster tax code compliance for all types of pension plans, these efforts, in our view, are better concentrated on large defined benefit plans.

Program Undertaken to Identify Abusive Tax Practices

A major part of the controversy focused on IRS's intent when it initiated a program to audit small defined benefit pension plans. Many plan sponsors and their actuaries came to believe that IRS initiated the program primarily to raise federal revenues at the expense of plan sponsors, not, as IRS claimed, to identify abusive tax practices. While revenue considerations did play a role in IRS's decision to examine small plans, we found nothing in the program documents to support the allegation that the audit program was primarily aimed at generating revenue.

IRS initiated its small pension plan audit program believing that significant tax abuse would be uncovered. Independent tax experts had long supported the view that defined benefit plans were popular among the self-employed and other proprietary employees because of their value as

tax shelters.[2] The tax experts believed that because standards of actuarial reasonableness were vague and dependent on an actuary's judgment, taxpayers pushed the standards to an extreme in order to maximize allowable contributions.

In late 1985, during the pilot phase of its small plan audit program, IRS issued more than a dozen technical-advice memorandums on examined cases where it disallowed deductions for pension plan contributions on the basis of unreasonable funding methods, actuarial assumptions, or both. In these cases, which covered the 1982 tax year, each plan's actuary usually assumed 5-percent interest rates and a retirement age of 55 that produced large tax deductions of $100,000 or more for pension plan contributions. Concluding that these assumptions were not reasonable, IRS substituted assumed interest rates of 8 percent and a retirement age of 65 in recalculating a lower allowable deduction for pension contributions. These latter assumptions were adopted by IRS in 1989 as safe harbors when it expanded the audit program. IRS cited various studies in support of its position.[3]

The decision to expand the small defined benefit pension plan audit program was prompted by a 1989 federal court decision. This decision affirmed IRS's position concerning the unreasonableness of a 5-percent interest rate assumption for 1980, when safe investments were yielding 12 percent or more.[4] At the same time, the IRS Assistant Commissioner for Employee Plans/Exempt Organizations (EP/EO) became convinced that excessive deductions by small defined benefit pension plans were a national problem. In launching the national audit program in November 1989, agents were advised to challenge pension plan funding assumptions that assumed retirement before age 65 and interest rates below 8 percent.

[2]One pension expert, Leon Irish, testified in June 1990 before a congressional panel that for more than a decade very aggressive plan design and funding practices were clearly developing. As a result, some highly paid professionals were claiming inflated pension deductions on their tax returns. See, Tax Notes Today, June 7, 1990. Also, see Norman Stein, "Some Policy Implications of the IRS's Small Defined Benefit Plan Audit Program," Tax Notes, June 8, 1992.

[3]IRS held that it is reasonable to assume that doctors, lawyers, and other self-employed professionals will not retire before age 65, absent specific and reliable evidence to the contrary. As to an 8-percent interest rate, IRS believed that most plans could have expected to earn at least that much investing in safe assets, such as medium-or long-term government securities.

[4]In 1988, the U.S. District Court for the Central District of Illinois decided in favor of the IRS in Mirza v. United States. The Seventh Circuit Court of Appeals affirmed this decision unanimously in August 1989. The court upheld IRS in its finding that a two-person plan sponsor's pension contribution for the year was excessive by more than $500,000, producing an income tax deficiency of $227,400.

Revenue Considerations Played a Secondary Role

Certain members within the actuarial community came to believe that the IRS small pension plan audit program was merely an attempt to generate federal revenue when IRS designated the program as a special revenue initiative. As the audit program expanded IRS said that the Office of Management and Budget asked it to determine if any revenue-producing activities were under way or planned that had not been previously included in the Treasury Department's proposed fiscal year 1991 budget.

Reflecting the optimism then surrounding the program, IRS estimated that it could generate additional tax revenue of up to $800 million, with disallowances expected in 85 percent of the cases. IRS later conceded that this estimate was a poor one based on incomplete data and that this conclusion was confirmed by subsequent experience in implementing the program.[5]

By introducing revenue considerations, IRS's actions had the effect of heightening longstanding differences between IRS and the actuarial community over appropriate assumptions. This underlies the additional accusations raised by the actuaries that IRS was targeting small (family-owned) businesses and not considering taxpayer facts and circumstances in reviewing the deductions claimed by plans.

IRS Actions Raised Actuaries' Concerns

The actuarial community initially became concerned about IRS's plans to audit small defined benefit pension plans in 1984. At that time, IRS developed audit guidelines and initiated a pilot project to examine these plans in California. The American Society of Pension Actuaries (ASPA) argued that IRS enforcement authority did not extend to considering the reasonableness of actuarial assumptions and that the Congress intended that IRS defer to the judgment of the plan's enrolled actuary. However, IRS reiterated its belief that it, not actuaries enrolled by the Joint Board, is

[5]It also has been suggested that IRS's designation of some terminated plans for review supports the view that the agency was primarily auditing small plans as a way to boost federal revenues. Indeed, when IRS expanded its small pension plan audit program in 1989, it knew that some tax practices it was targeting had already been curtailed through legislation. In this regard, many small pension plans were terminated in response to the Tax Reform Act of 1986 and the Omnibus Budget Reconciliation Act of 1987. For instance, individual defined benefit plans for partners in law firms and similar organizations originally allowed under the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 were no longer permitted. IRS reported that 2,300 of its examinations were of these so-called TEFRA plans. However, IRS decided to audit these plans before it designated the small plan audit program as a special revenue initiative.

We also note that in 1991 we questioned the IRS decision to spend resources on examining small pension plans on the grounds that they posed no significant risk to participants and the Pension Benefit Guaranty Corporation. See, Pension Plans: IRS Needs to Strengthen Its Enforcement Program (*GAO/HRD-91-10, July 2, 1991*).

responsible for determining the reasonableness of assumptions employed in calculating pension plan contributions.

The controversy escalated as the audit program expanded. Actuaries perceived IRS actions as arbitrary, inconsistent, and unfair. For years, in qualifying plans for tax deferred status, IRS had accepted plan provisions showing retirement ages of less than 65 and interest rates in the 5- to 8-percent range. In November 1989, however, IRS began to challenge these same conservative assumptions when they were used to calculate contributions. IRS then notified taxpayers that using these assumptions for determining annual pension contributions was unreasonable.

In challenging the assumptions, IRS seemed to be disavowing its 1984 audit guidelines, certain public pronouncements of IRS officials, and the ERISA premise concerning permissible use of a range of reasonable assumptions. IRS did not accept the actuarial community's argument that assumptions for small plans should be more conservative than for large plans because small plans are riskier.

Furthermore, practitioners and plan sponsors were not cautioned about their assumptions until they were sent a determination letter[6] informing them that acceptance of such assumptions for qualifying purposes did not mean IRS accepted them as reasonable for determining annual pension contributions. From 1986 to 1988, many plan sponsors filed Form 5500 series information returns with IRS that showed annual pension contributions based on conservative actuarial assumptions. These assumptions were consistent with then accepted IRS practice in qualifying the plan.

Program Expansion Not Well Planned

IRS also moved swiftly to a nationwide program in 1989 to avoid the statute of limitations that was expiring on many plan returns. In so doing, it did not provide a public comment period, as it sometimes does, that may have brought attention to issues and questions needing immediate resolution. For example, IRS could have addressed questions about how the safe harbor assumptions were derived and how they were to be applied as well as requests from ASPA on how the $800 million revenue estimate was derived. Initially, IRS also did not provide definitive guidance or the necessary training to agents inexperienced in examining defined benefit plans.

[6]When a pension plan is filed for approval with IRS, and after the plan is changed to reflect IRS exceptions, IRS sends a determination letter. This letter becomes a permanent part of the plan file, and must be referred to in all future contact with IRS until a later determination letter supersedes it.

IRS later conceded that mistakes were made. In July 1991, the IRS Assistant Commissioner for EP/EO told an ASPA conference that IRS had made some mistakes because its agents were not experienced in examining pension plans. The cases also were more complicated than expected. Agents were especially at a loss on how to handle cases where a plan was terminated and its assets already distributed to participants. Belatedly, IRS placed actuaries in seven district offices that had EP/EO agents to ensure adequate consideration of taxpayer facts and circumstances, and, for awhile, referred cases to headquarters for review. IRS also issued new guidance and increased training efforts.

Moreover, because EP/EO agents were not authorized to adjust tax returns, disputed cases had to be referred to agents in the Examination Division for further processing and assessing of taxes and penalties. Long delays in settling cases ensued, creating congressional concern. Initial plans by IRS to examine 18,000 returns were scaled back. Eventually, 15,646 returns were examined.

Thousands of Cases Unresolved Despite Attempts to Speed Resolution

In response to taxpayer requests and congressional concerns, in July 1991, IRS implemented an Actuarial Resolutions Program (ARP) to provide taxpayers with an opportunity for quick resolution of their cases. In return for taxpayers' agreeing to pay all taxes resulting from the proposed adjustment to the plan, IRS agreed to waive excise taxes and other penalties on the disallowed amount. As of March of this year, 2,964 ARP cases had been settled for $45.6 million in proposed tax deficiencies or $15,373 per case. In another 3,228 cases involving $74.8 million in proposed tax deficiencies and $50.5 million in penalties, the taxpayers rejected ARP offers and filed an appeal with IRS (see app. III).

Subsequently, IRS lowered its original revenue estimate for the program to $168 million, including ARP. IRS may have to settle for even less as recent U.S. Tax Court rulings have resulted in fewer sponsors agreeing to ARP settlements. The final amount may never be known because IRS does not have a reliable system for tracking program accomplishments. We estimate, though, on the basis of ARP statistics and appeals data provided, that several thousand cases were unresolved as of March 1993. Thus, IRS apparently will be entangled in these issues for many more years—despite the efforts of ARP to resolve them.

Program Did Not Target Small Businesses

Another major complaint against IRS was whether the program was targeting small (family-owned) businesses rather than focusing only on those with large contributions in an attempt to maximize revenues. IRS data show, and our review of completed examination files confirms, that most audited plan returns were those of highly paid professionals, such as physicians, attorneys, brokers, and engineers (see app. IV).[7] Plans of some traditional family-owned businesses, such as a funeral home or a pawnbroker, were examined by IRS but such businesses did not constitute a large share of the plans examined. Some plans covered one or more executives of larger businesses whose rank and file employees were likely covered under a separate retirement plan.

The concerns about targeting small businesses were reinforced by IRS's decision to reduce the threshold contribution amount for plans that it would review and to examine cases below the threshold. The original threshold for review was $100,000 per participant but this was reduced to $60,000 as the program progressed. Even then, IRS did not adhere to its reduced criterion of only examining plan years for which the annual contribution per participant exceeded $60,000.[8]

This lack of adherence to its own criteria occurred for several reasons. If IRS selected a return for one plan year, it usually audited previous or later plan years for which the statute of limitations had not expired. In these years, plan contributions were often smaller. If one plan of a sponsor met IRS criteria for examination, IRS would then examine all small plans of that sponsor, regardless of the contribution. However, according to an official in the Los Angeles district, some returns were selected based solely on their conservative funding assumptions (e.g., a 5-percent interest rate and retirement at age 55) irrespective of the annual contribution.

IRS Considered Taxpayer Facts and Circumstances

Our review of 172 completed examination cases disclosed that IRS, consistent with its stated policy, considered taxpayer facts and circumstances in determining the reasonableness of interest rate and retirement age assumptions. Agents reviewed investment results; key plan provisions; actuarial information, including funding method and other possible offsetting actuarial assumptions; and taxpayer-provided material

[7]Based on available data, the median annual income for the principal participant in the plans of cases we reviewed was $155,900.

[8]Almost 50 percent of our sample cases did not meet the reduced limit.

on health and retirement intentions.[9] IRS actuaries at the national office or at the district offices were consulted for advice at the discretion of the EP/EO agent.

We noted several examples where IRS accepted a retirement age of less than 65 on the basis of evidence that the taxpayer was retiring early for medical or other reasons. Interest rate assumptions in the 5- to 7.5-percent range were accepted when the agent concluded such rates were supported by investment results or plan provisions (see app. V).[10]

In many cases, however, IRS did not find the evidence or arguments used to support lower interest rate or retirement age assumptions to be convincing or sufficient. For example, IRS did not accept the argument of an actuary who assumed his client would retire early for health reasons but did not submit medical evidence to support his claim. In other situations, IRS substituted an age 65 retirement because the taxpayer had not produced statistics pointing to a pattern of retirement by age 55 of persons in comparable circumstances.

IRS data show tax adjustments were recommended for 70 percent of the 15,646 returns examined (change cases). In 128 of the 143 change cases we reviewed at district offices in two of the seven IRS regions, IRS had determined that the taxpayer's actuary calculated the plan contribution using one or more unreasonable actuarial assumptions (see app. V). IRS then recalculated an allowable contribution substituting what it considered to be reasonable assumptions. Overall, the mean excess annual pension plan contribution in the 143 change cases we reviewed was $68,723 or 57 percent of the average annual plan contribution of $119,770 (see app. IV).

If a taxpayer disagreed with the proposed tax adjustment for excessive pension contributions or an ARP offer, other options were available, such as using the IRS appeals process or taking the case to Tax Court or a federal District Court. ASPA countered that these are expensive options and, thus, taxpayers are pressured into agreement at an earlier stage

[9]IRS stated that in a substantial number of cases all or most of the contribution was disallowed due to the use of an inappropriate funding method or some other technical violation without addressing the interest rate and retirement age issues. However, we identified such technical issues (other than interest rate or retirement age) as a factor in disallowances in less than 10 percent of the randomly selected case files we reviewed in the Midwest and Western Region. An IRS EP/EO official said that such cases were concentrated in two other regions.

[10]These situations were discussed at a 1992 meeting of Enrolled Actuaries where a pension law expert related that IRS was accepting definite, documented plans for early retirement and accepting interest rate assumptions based on actual investment experience for plans with at least 3 years' experience.

without their cases getting a full airing. Moreover, ASPA said that the actuary advising the appeals officer likely would be the same one that initially advised the EP/EO agent. IRS concurred, but said that the process is no different than other tax audits where a specialist might advise an agent and later an appeals officer.

Conversely, the cases where IRS did not propose an adjustment did not result only from IRS accepting the plan's funding assumptions. For example, in 7 of the 29 so-called no-change cases we reviewed, the contribution was allowed because conservative interest rate assumptions, retirement age assumptions, or both, were counterbalanced by the lack of a salary scale assumption (see app. V). In 10 of the cases reviewed, IRS substituted one or more of its safe harbor assumptions but did not pursue an adjustment because it considered the tax deficiencies inconsequential.

IRS Lost Key Tax Court Cases

The ultimate resolution of most appealed cases will be influenced by recent and future court decisions. Three recent test cases were decided against the IRS position and this suggests that IRS may be unable to support its assumptions for computing allowable pension contributions.

On July 14, 1992, the U.S. Tax Court ruled in favor of the petitioners and against the IRS challenge of the plans' interest rate and retirement age assumptions.[11] The cases involved individual defined benefit plans of partners in two law firms and involved millions of dollars in proposed disallowances of pension deductions.

The court held that the petitioners proved that the 5-percent interest rate assumptions used in both cases were reasonable for the 1986 tax year and, for one firm, the 1987 tax year, and the assumed retirement ages of 55 and 62 in the respective cases were reasonable. Because IRS did not prove that the assumptions were substantially unreasonable, the court held that IRS must defer to the judgment of the plans' actuaries and not retroactively adjust the tax deductions for pension contributions.

In September 1992, the U.S. Tax Court ruled against IRS in a third test case that combined 12 cases where IRS challenged the reasonableness of actuarial assumptions and pension plan funding methods used by small business sponsors of defined benefit plans for one or two people.[12] The

[11]The two cases were Wachtell, Lipton, Rosen & Katz v. Comm'r, 64 T.C.M. (CCH) 128 (1992); and Vinson & Elkins v. Comm'r, 99 T.C. 9 (1992).

[12]Citrus Valley Estates, Inc. v. Comm'r, 99 T.C. 21 (1992).

court ruled that the 5-percent preretirement and postretirement interest rates used in all plans and age 55 retirement assumptions used in some plans were reasonable.

The Solicitor General has filed an appeal with the U.S. Court of Appeals on behalf of IRS in one of the test cases (Vinson & Elkins v. Comm'r). IRS has indicated its intention to appeal the other two cases as well. Also, as of May 1993, IRS had lifted the suspension on processing of cases in the IRS appeals process that had been in effect since the July 1992 Tax Court decisions.

Implications of Pending Legal Decisions

The outcome of the pending IRS appeal in the Court of Appeals could have important implications for the future independence of actuaries in selecting plan funding assumptions. From the Treasury Department perspective, if the current Tax Court decisions are upheld on appeal, IRS could lose control over the determination of reasonable actuarial assumptions used in funding plans. Then actuaries clearly would have wide discretion in setting assumptions to fund defined benefit plans. Thus, the plan sponsor could continue to make large contributions, as many plans did during the years IRS audited.

Aggressive plan funding also could bring a greater number of plans up to the allowable contributions dollar limits. This practice could allow additional tax expenditures for plans that are set up primarily to provide large dollar tax deductions for highly compensated individuals rather than for sound retirement planning.

If the IRS position is upheld on appeal, IRS's authority to set standards of reasonable actuarial assumptions could be vindicated. Continuing the practice of oversight of actuarial assumptions could result in overall pension plan contributions that are presumably more consistent with sound retirement funding.

From an actuary's perspective, if the current Tax Court decisions are upheld on appeal, the actuary would appear to be solely responsible for selecting assumptions. This selection would be based on the actuary's judgment of the risks facing the plan and the funds needed to provide the required benefits at retirement. If the IRS position is upheld, the actuary could lose control over the assurance that assets will be sufficient to provide required benefits at retirement.

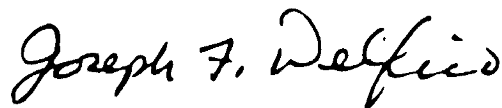
Agency Comments

IRS concurred with our findings concerning its reasons for undertaking the actuarial audit program, whether it targeted small business, and whether it considered taxpayer facts and circumstances in auditing returns (see app. VI). In response to our conclusion that it should focus its examination efforts on large defined benefit plans, IRS noted that it has selected 400 underfunded defined benefit plans with 100 or more participants for review.

IRS also stated its belief that the outcome of the appeals of the actuarial test cases has implications not only for overfunded small pension plans but also for IRS's review of the actuarial assumptions of underfunded pension plans. IRS believes that this is an important matter and added that it is one that contributed to its decision to appeal the test cases.

We also met with IRS staff to receive their comments on our draft report concerning a few technical matters. We made changes in the final report where appropriate.

We are sending copies of this report to other interested congressional committees and will make copies available to others who request them. If you have any questions, please contact me on (202) 512-7215. The major contributors to this report are listed in appendix VII.



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Abbreviations

ARP	Actuarial Resolutions Program
ASPA	American Society of Pension Actuaries
EP/EO	Employee Plans and Exempt Organizations
ERISA	Employee Retirement Income Security Act of 1974
IRS	Internal Revenue Service
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982

Objectives, Scope, and Methodology

The objectives of our study were to examine the validity of complaints concerning the reasons IRS undertook a program to audit small defined benefit pension plans, whom the program targeted, and whether IRS considered taxpayer facts and circumstances in reviewing actuarial assumptions.

To address these objectives, we reviewed background information concerning the IRS small defined benefit pension plan audit program, including articles published in professional journals on the subject by pension and tax experts. We also reviewed various internal policy documents, directives, guidance issued to IRS field offices, and program statistics. In addition, we interviewed officials from IRS, ASPA, the American Academy of Actuaries, and independent experts in the pension field.

We drew a random sample of 1 percent of IRS no-change cases (returns audited with no proposed adjustments). For logistical reasons, drawing a random sample from the universe of IRS change cases (returns audited with proposed adjustments) was impractical. However, we drew random samples for subsets of the universe from the Midwest and Western Regions, two regions with dissimilar audit result characteristics. The Western Region had a relatively high change rate while the Midwest Region had a relatively low change rate. In total we analyzed 143 change cases and 29 no-change cases.

We reviewed the sample cases to determine if IRS considered taxpayer facts and circumstances during its examination of small defined benefit plan returns. We also extracted other data, such as the income of the principal plan participant, type of business, actuarial assumptions for the plan year, and status of the case. We did not make, nor are we making, any assessment of taxpayers' or IRS's position on the reasonableness of actuarial assumptions or any other tax issue. Our policy is to not investigate and report on the tax status of specific taxpayers identified for us by others or to question IRS's judgment in individual tax cases.

Our audit work required us to use data generated by IRS management information systems and other adjunct systems. We did not assess the reliability of these data. However, we reviewed the data for reasonableness and consistency, and attempted to resolve any discrepancies.

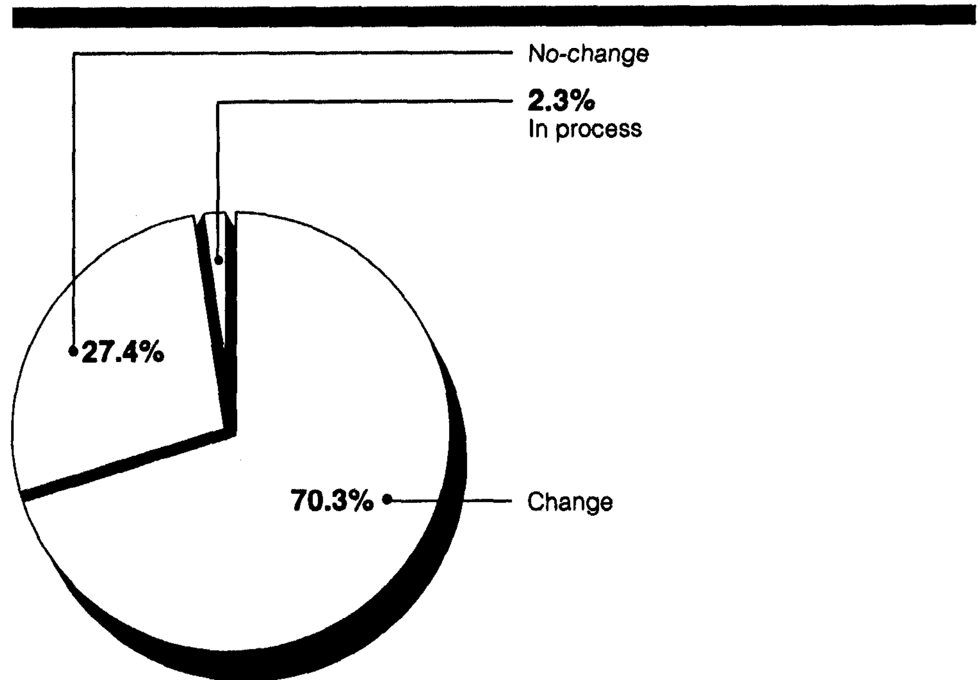
We did our audit work between January and September 1992 in accordance with generally accepted government auditing standards.

Scope of the Small Plan Audit Program

According to IRS data, the small defined benefit pension plan program encompassed 15,646 plan years. Assuming that IRS examined an average of 2 plan years for each plan selected, we estimated that IRS examined about 7,823 plans, or less than 10 percent of the more than 100,000 plans with one to five participants in effect during the 1986-88 time frame of the program. The actual number of plan sponsors may be less than our estimate of 7,823 plans because our sample noted several instances of employers sponsoring multiple small defined benefit plans.

As figure II.1 shows, the EP/EO Division had completed 97.7 percent of its 15,646 plan year examinations as of September 1992. The division reported proposed changes in 70 percent of the completed cases. However, that percentage overstates somewhat the number of cases for which an actual adjustment took place. For example, in our Midwest and Western regional samples, proposed changes did not occur in 19 of the total 143 change cases we examined for a variety of reasons, such as little or no tax effect.

Figure II.1: Total Plan Years in the IRS Small Pension Plan Audit Program as of September 1992



Total plan years = 15,646.

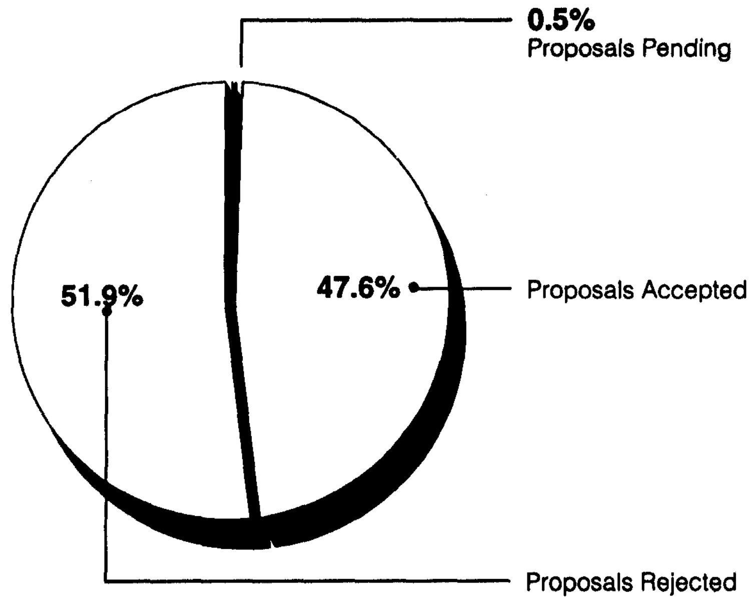
Source: IRS.

Most Plan Sponsors Did Not Agree to IRS Adjustments

In July 1991, at the EP/EO audit level, IRS initiated the Actuarial Resolutions Program to expedite and resolve actuarial assumption issues. IRS reports data for ARP on the basis of the number of plan years for which changes are proposed. We found that a total of 6,224 plan years were processed in ARP. Figure III.1 shows the percentage of offers issued to plan sponsors that were either accepted or rejected or were pending a response from the sponsor. The figure does not include any offers that are being prepared. IRS expected to make ARP settlement offers through July 1992, but IRS said a few offers were made after that date.

ARP gave taxpayers the option of agreeing to the proposed tax deficiency in exchange for a waiver of excise tax and penalties. A 10-percent excise tax is imposed on the excess assets held in the pension trust as a result of IRS proposed actuarial assumptions. ARP does not exclude the taxpayer from normal appeals procedures. However, ARP eliminated any incentive to agree with IRS's proposals at the audit level. We believe three recent Tax Court decisions that ruled against IRS's actuarial assumptions position may further reduce any incentive to accept ARP offers.

Figure III.1: Status of Plan Years in the Actuarial Resolutions Program as of March 1993

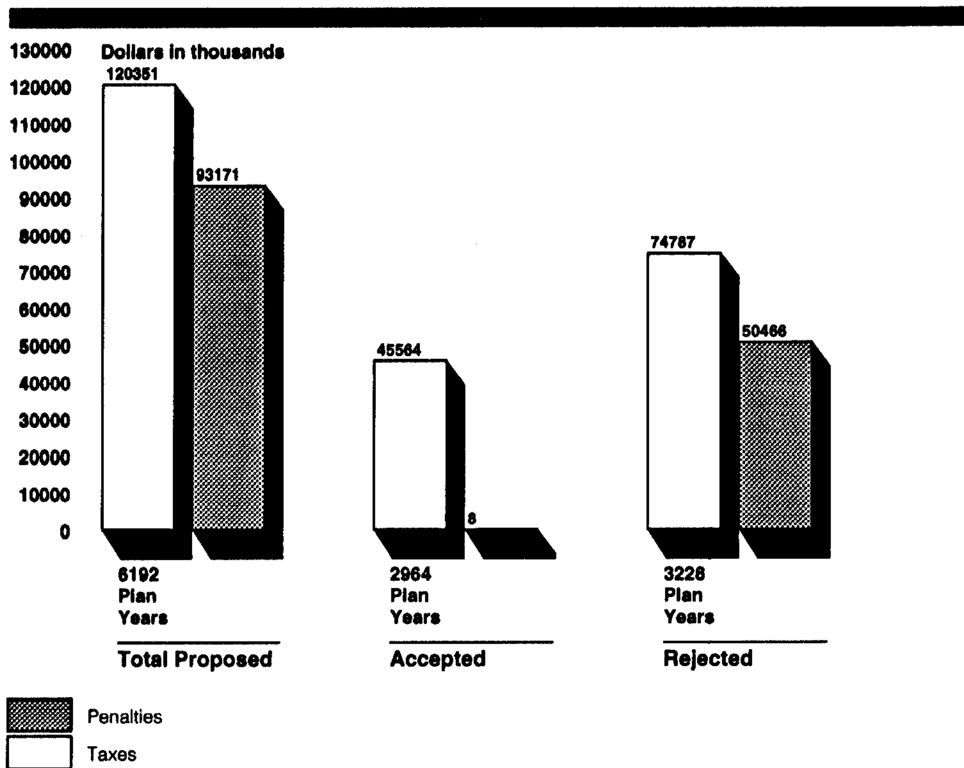


N = 6,224.

Source: IRS.

Figure III.2 displays the information in figure III.1 regarding accepted and rejected cases in dollar amounts. Figure III.1 indicates that (excluding pending proposals) 48 percent of ARP offers were accepted, and figure III.2 shows that accepted tax adjustment offers constituted 38 percent of the total proposed changes in dollar terms. The average recovery of taxes per plan year is $15,373.

Figure III.2: Total Proposed, Accepted, and Rejected Tax and Penalties in the Actuarial Resolutions Program as of March 1993



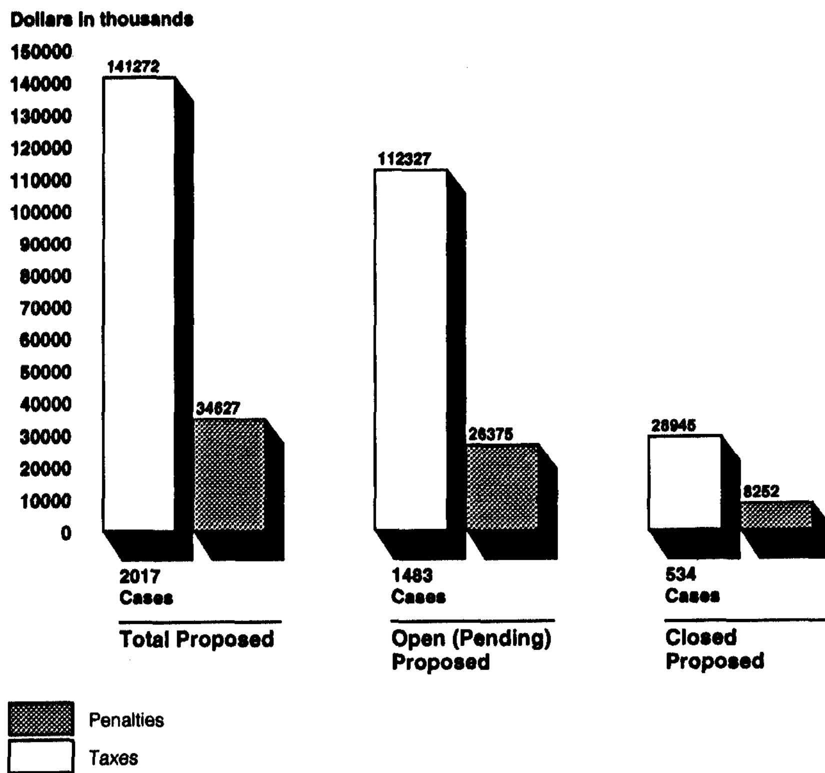
Source: IRS.

The IRS Appeals Office received 2,017 cases during the period October 1991 through March 1993. It should be noted that the ARP tracking system and the Appeals Office are independent of each other. The Appeals Office records all related plan sponsors and related plan years as a single unit. The EP/EO Division records each plan year as a single unit. Therefore, no correlation can be made between the two divisions' results.

Figure III.3 shows that 26 percent (534/2,017) of the cases that reached the appeals stage were closed. Total proposed taxes in closed cases amounted to $28,945,000 and $8,252,000 in penalties. However, 74 percent (1,483/2,017) of the cases remained open in the Appeals Office. In terms of

dollars, $112,327,000 in taxes and $26,375,000 in penalties, or 79 percent of the dollars, were pending in the Appeals Office.[1]

Figure III.3: Proposed Dollars Sent to and Processed in IRS Appeals Offices From October 1991 Through March 1993



Source: IRS.

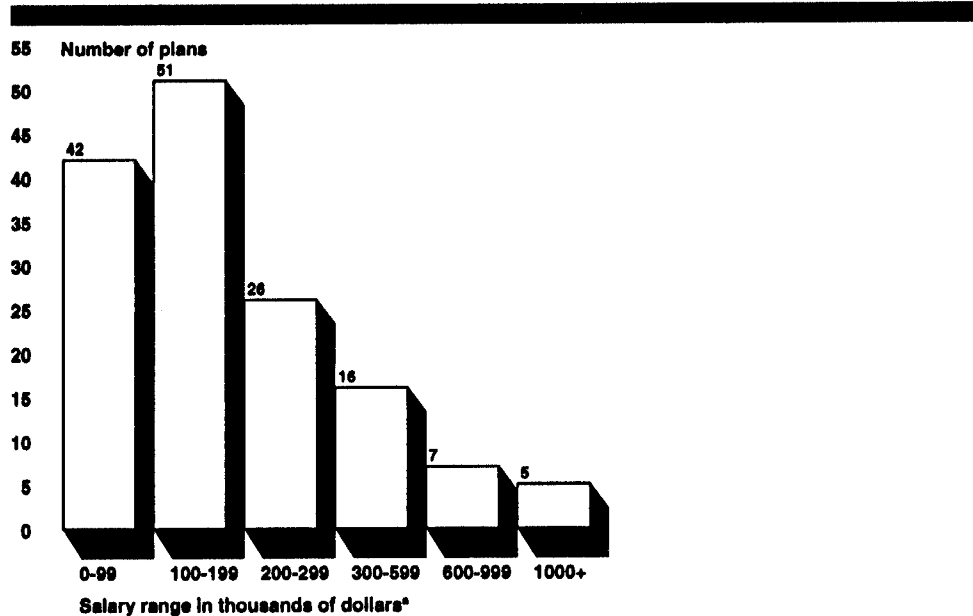
[1]A large number of unagreed cases had been in suspension at the EP/EO examination level pending IRS appeal of the Tax Court decisions. As a result of filing an appeal in Vinson & Elkins v. Comm'r, beginning May 4, 1993, IRS has lifted the suspension and cases can now move onto the appeals stage.

Program Targeted High-Income Individuals

To determine whom IRS targeted in its audit of small pension plans, we studied available income data from our sample of 172 case files. We also compiled information on the average contribution and IRS adjustment for the 143 change cases in our sample.

Figure IV.1 presents income data based on our sample of 143 change cases from the IRS Midwest and Western Regions, and a sample of 29 cases drawn from a nationwide universe of no-change cases. However, income data were not available for all case files, and only the income of the key participant (such as business owner or president of the plan sponsor) in plans with more than one participant is included in our analysis. We did not take into account a participant's contribution to the respective defined benefit plans when computing salary or net income.

Figure IV.1: Income Range of 147 Key Participants in Sample of Defined Benefit Plans



[a]Income is for key participants only.

Source: Nationwide sample of no-change cases and samples of change cases from IRS Midwest and Western Regions.

Our analysis indicated that 71 percent of 147 defined benefit plan key participants we identified received salaries or net earnings from self-employment in excess of $100,000. Only nine participants or 6 percent

received salaries of less than $50,000. A large majority, 75 percent of our sample, had salaries ranging from $50,000 to $300,000. The median income was $155,900.

Our finding that the program targeted high-income individuals is supported by an internal IRS study. IRS conducted an income study in its Cincinnati district based on tax returns of participants in pension plans that were in the small pension plan audit program. Of the 226 cases in the program, only 107 participants' incomes could be determined. The average income was $547,000.

Table IV.1 shows the average contribution per plan and the average IRS adjustment to the 143 change cases. If those contributions were included in participants' incomes, taxable compensation would increase substantially. Table IV.1 also shows that the amount allowed per plan after the adjustment proposed by IRS is substantially more than the average contribution to either an individual retirement account ($2,435) or a Keogh plan[1] ($7,998) in 1986.

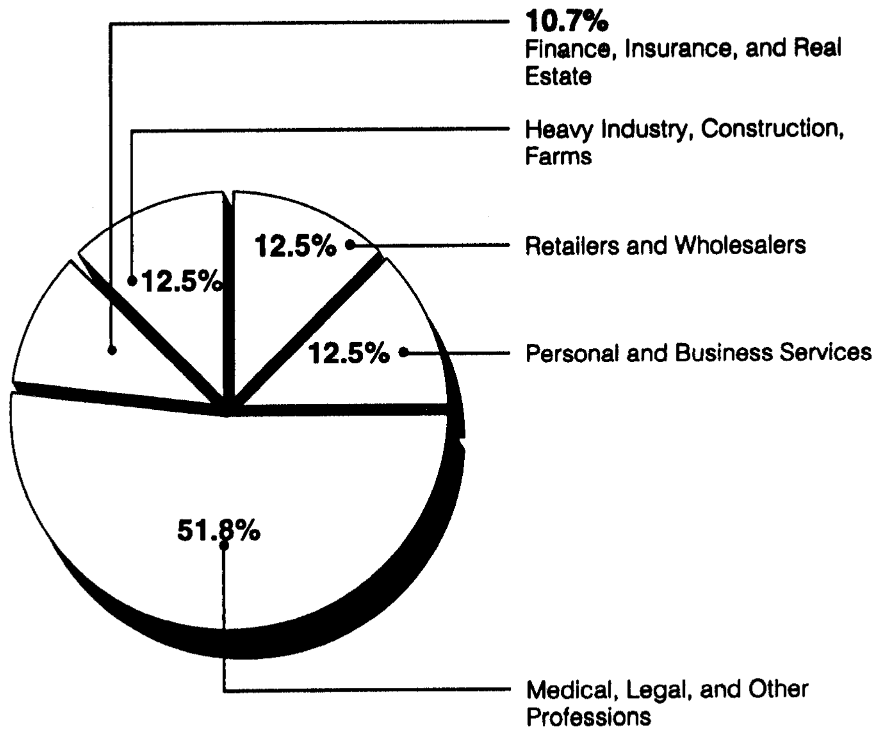
Table IV.1: Average Contribution and Adjustment Per Plan

		Contribution		Adjustment	
No. in plan	No. of plans	Total contributions	Average per plan	Total adjustments	Average per plan
1	71	$ 6,712,384	$ 94,541	$4,346,003	$61,211
2	32	3,752,207	117,256	2,107,480	65,859
3	19	2,857,761	150,408	1,751,940	92,207
4	14	2,718,148	194,153	1,109,584	79,256
5+	7	1,086,653	155,236	512,420	73,203
Total	**143**	**$17,127,153**	**$119,770**	**$9,827,427**	**$68,723**

The small pension plan audit program included a wide variety of business types. However, our sample and IRS's data, shown in figure IV.2 and figure IV.3, respectively, disclosed that medical, legal, and other professions accounted for more than 50 percent of the industries. The balance of figures IV.2 and IV.3 shows the plan sponsors in manufacturing; construction; retail and wholesale trade; financial, insurance, and real estate services; and personal and business services.

[1] A Keogh plan is a tax qualified pension or profit sharing plan designed for self-employed persons.

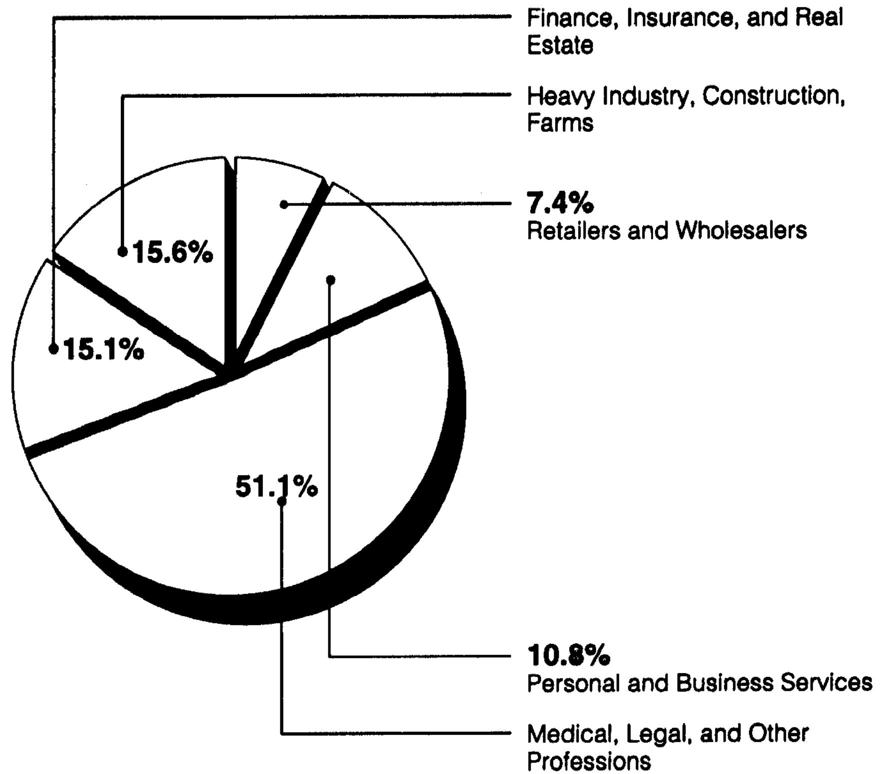
Figure IV.2: Industries of Plan Sponsors in Samples Drawn in June and July 1992



N=168

Source: GAO sample of change cases from IRS Midwest and Western Regions, and GAO sample of nationwide no-change cases.

Figure IV.3: Industries of Plan Sponsors Examined by IRS as of November 1992



N = 13,885

Source: IRS.

IRS Acceptance and Non-Acceptance of Actuarial Assumptions Below Safe Harbor Assumptions

Change Sample

Under the IRS small defined benefit pension plan program, EP/EO agents were to challenge actuarial assumptions below the safe harbor levels. Assumptions below those levels would have had interest rate assumptions of less than 8 percent for periods before and after expected retirement, and retirement age assumptions under age 65.

In our sample of change cases in the Midwest and Western Regions, we identified 128 cases where IRS did not accept as reasonable one or more assumptions less than its safe harbors and, thus, proposed disallowing all or a portion of the pension plan deduction. Nevertheless, we found that IRS did consider taxpayer facts and circumstances and in some cases accepted as reasonable plan funding assumptions less than its safe harbors. This occurred in 58 cases, or 45 percent of the total change cases.

Table V.1 shows the total of 91 assumptions accepted below safe harbors for the 58 cases we identified. The table shows the distribution of the accepted assumptions by type of assumption for the two regions we studied. The total of 91 assumptions in the table reflects 33 cases that had 1 assumption accepted and 25 cases that had 2 or more assumptions accepted.

Table V.1: Actuarial Assumptions Accepted Below Safe Harbors

Expected retirement age under 65			
Age	Midwest	Western	Combined
55	3	4	7
56	1	1	2
60	5	3	8
62	3	2	5
64	1	0	1
Subtotal	**13**	**10**	**23**
Preretirement interest rate below 8 percent			
Rate (percent)	Midwest	Western	Combined
5.0	2	5	7
5.5	1	0	1
6.0	6	4	10
6.5	0	1	1
7.0	0	2	2
7.5	1	0	1
Subtotal	**10**	**12**	**22**
Postretirement interest rate below 8 percent			
Rate (percent)	Midwest	Western	Combined
5.0	19	19	38
5.5	1	1	2
6.0	3	1	4
7.0	1	1	2
Subtotal	**24**	**22**	**46**
Total	**47**	**44**	**91**

In 70 of the 128 cases we studied, IRS substituted one or more safe harbor assumptions resulting in a complete disallowance of the pension contribution deduction. In some of these cases, one or more assumptions below safe harbors may have been accepted, but the result was moot due to the complete disallowance of the deduction.

No-Change Sample

While IRS considered facts and circumstances in the 29 no-change sample cases we reviewed, the decision to allow the contribution was not always because IRS accepted as reasonable assumptions that were below its safe harbor assumptions. In 10 of the no-change sample cases, no adjustment was made even though interest rate assumptions, retirement assumptions,

or both, were below safe harbor levels. In 17 of the other 19 cases, the reasonableness of the retirement age and interest rate assumptions was not an issue either because (1) any adjustment as a result of substituting safe harbor assumptions would be minimal (10 cases) or (2) conservative retirement and interest rate assumptions were offset by other factors, such as the lack of a salary scale assumption (7 cases).[1]

[1]A salary scale assumption relates to whether the pension contribution computation assumes rising or constant future wages or salaries. If salaries are not assumed to rise over time, the amount required to fund a plan (and the contribution) will be smaller. This can offset conservative interest rate or retirement assumptions, which tend to raise the amount needed to fund a plan.

Comments From the Internal Revenue Service

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

COMMISSIONER

MAY 21 1993

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

Dear Mr. Delfico:

This is in response to your draft report entitled "SMALL PENSION PLANS: Concerns About the IRS Actuarial Audit Program." We appreciate the opportunity to comment on it.

Your report addresses the complaints of the actuarial community about three aspects of the Service's program, undertaken in 1989 and now completed, to examine small defined benefit pension plans: why the Service undertook the program; whom the program targeted; and whether the Service considered taxpayer facts and circumstances in determining whether the actuarial assumptions used by a plan were reasonable.

With respect to the Service's reasons for undertaking the program and whom the program targeted, your report concludes that the complaints of the actuarial community were not well founded. You note that you found no evidence that the Service singled out small business owners for examination; rather, you found that the Service targeted small plans with large pension deductions whose principal participant was usually a highly paid professional. You also found that the Service, in conducting the program, did not rigidly impose its safe harbor actuarial assumptions, but considered the taxpayer's facts and circumstances in each case. We are gratified by these findings, and we concur in them.

The conclusion of that portion of your report entitled "Results in Brief" suggests that while the Service should continue its efforts to foster tax code compliance for all types of pension plans, these efforts are better concentrated on large defined benefit plans than on small plans. We wish to point out that we have now allocated our examination resources over a broad spectrum of plans, including, by way of example, approximately 400 underfunded defined benefit plans with more than 100 participants.

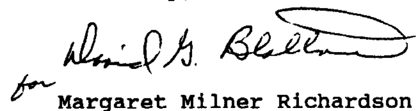
Finally, we wish to address your comments concerning the actuarial test cases. As we discussed with GAO representatives on May 17, 1993, the same statutory standard concerning the reasonableness of actuarial assumptions which applies to problems of excessive deductions also applies to problems of underfunding. The actuarial test cases are therefore of importance not only

Mr. Joseph F. Delfico
Page 2

with respect to the abusive overfunding of small plans, the situation which gave rise to the actuarial program, but also with respect to the underfunding of large plans, a matter of current national concern. This latter concern, together with our conviction that the Court erred in the actuarial test cases themselves, contributed to our recommendation to appeal the test cases.

Thank you again for the opportunity to comment on this report. We hope that you will find this information useful.

Sincerely,



for Margaret Milner Richardson

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