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Report to Congressional Requesters

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PRIVATE PENSIONS

IRS Can Improve the Quality and Usefulness of Compliance Studies

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Abbreviations

ASA	American Statistical Association
Audit CAP	Audit Correction Agreement Program
DC	defined contribution
ERISA	Employee Retirement Income Security Act
GAO	General Accounting Office
IRC	Internal Revenue Code
IRS	Internal Revenue Service
PWBA	Pension and Welfare Benefits Administration
SCP	Self-Correction Program
SIMPLE	Savings Incentive Match Plan for Employees
VCP	Voluntary Correction Program

United States General Accounting Office
Washington, DC 20548

April 12, 2002

The Honorable Max Baucus
United States Senate

The Honorable Bob Graham
United States Senate

The Honorable Orrin Hatch
United States Senate

The Honorable James Jeffords
United States Senate

To encourage employers to establish and maintain pension and savings plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for plans that meet certain requirements. In fiscal year 2002, these tax preferences for employer-sponsored pension plans are estimated at about $88 billion and represent the largest federal "tax expenditure," exceeding those for either home mortgages or health benefits.[1]

The Internal Revenue Service (IRS) conducts audits and other enforcement and research activities to ensure that tax-qualified pension plans satisfy applicable requirements in exchange for preferential tax treatment. IRS monitors plan adherence to requirements primarily through audits but also through periodic compliance studies. Compliance studies are conducted by IRS to better design and implement enforcement activities, such as targeted plan audits, and provide information that IRS can use to inform pension plan sponsors and administrations about key aspects of noncompliance. In 2000, IRS released a study on 401(k) plan

[1]Joint Committee on Taxation, "Estimates of Federal Tax Expenditures for Fiscal Years 2002 2006," JCS-1-02 (Washington, D.C.: January, 2002). Pension contributions that fall within statutory limits, as well as investment earnings on pension plan assets, are not taxed until benefits are paid to plan participants.

compliance with certain statutory requirements that govern tax-qualified plans.[2]

To conduct the study, IRS selected a sample of 401(k) plans on the basis of information that plan sponsors filed with IRS for the 1993 plan year, and IRS agents answered study questions after they completed audits of these plans. The study, including the audits and data analysis, was conducted between 1995 and 1998, and IRS published the study results in 2000. IRS reported that 44 percent of the plans in the study had one or more instances of noncompliance with the statutory requirements IRS examined. Members of Congress are concerned about whether the stated noncompliance rate accurately describes the level of noncompliance among 401(k) plans.

In response to this concern, you asked us to (1) determine how the IRS conducted a study to estimate 401(k) plan noncompliance with the requirements of the Internal Revenue Code; (2) assess to what extent the study provided accurate estimates of the prevalence and types of noncompliance among 401(k) plans; and (3) describe IRS's plans for research on pension plan compliance.

To address your questions, we reviewed the IRS 401(k) plan compliance study published[3] in 2000 and work papers related to its design and implementation. We also interviewed IRS officials and analysts to obtain information on the design, implementation, and data analysis methods that IRS used to conduct the study. In addition, we compared IRS's study design, data collection, and analysis with published American Statistical Association (ASA) and GAO guidance on conducting research studies. Because IRS was not able to provide us with documentation, data, or both that support the published results, we were not able to assess IRS study results on specific types of noncompliance to verify their accuracy or determine whether the instances of noncompliance that IRS reported were significant. We reviewed IRS work plans in the employee plans area and

[2]A 401(k) plan allows an employee to optionally reduce his or her salary, subject to certain limits, in exchange for the opportunity to make tax-free contributions to a qualified retirement account, within certain limits (26 U.S.C. 401(k)). Investment income earned on section 401(k) account balances accumulates tax-free until the individual withdraws the funds. During the years covered by the IRS 401(k) study, only private taxable employers were eligible to establish a 401(k) plan. The Small Business Job Protection Act of 1996 permitted tax-exempt employers to establish 401(k) plans, effective January 1, 1997.

[3]IRS published the study report on its Web site (www.irs.gov).

interviewed IRS officials to identify plans for ongoing and future compliance research initiatives. We conducted our work between June 2001 and January 2002 in accordance with generally accepted government auditing standards (see app. I for details on our scope and methodology).

Results in Brief

To conduct the 401(k) plan compliance study, the IRS audited a sample of 401(k) plans and collected data to estimate noncompliance with certain requirements of the Internal Revenue Code. However, IRS's estimates on 401(k) plan noncompliance were generally inaccurate. IRS selected its study sample of 550 plans, each of which indicated a 401(k) plan feature for the 1993 plan year, from an agency database with information on all tax-qualified plans. To produce a representative sample, the IRS randomly picked equal numbers of plans from small, medium, and large plan size categories.[4] To obtain information on the characteristics, design features, and compliance of these plans, IRS used an already available study check sheet, or questionnaire, that included 254 questions to broadly gather information on 401(k) plans. Each of the 550 plans in the study was assigned to an IRS examiner for audit. IRS examiners who conducted the audits were provided with a copy of the questionnaire and were instructed to answer the study questions upon completing the audits. Once the data were gathered, IRS identified 73 out of the 254 study questions that it believed could indicate whether or not a plan was in compliance with certain requirements; IRS called these 73 questions "compliance indicators." IRS based its published results on an analysis of these indicators for 472 of the plans selected.[5] IRS data analyses produced estimates of the number of plans that failed to comply with one or more of their compliance indicators and the frequency of these violations. The study did not attempt to provide information on the severity of the compliance violations that IRS identified, nor did the study determine the number of plan participants or the amount of assets associated with these noncompliance errors.

The IRS study does not, in general, provide accurate estimates of the overall prevalence and types of noncompliance among 401(k) plans. This

[4]Additionally, the twenty-five largest 401(k) plans were included as a 100 percent sample of the super-large category.

[5]Upon reviewing the complete study information for all 550 plans, IRS excluded from its analysis 78 plans that either were not 401(k) plans or for which IRS had not obtained sufficient data.

is primarily because only 27 of the 73 study questions that IRS identified as compliance indicators conclusively demonstrated whether or not a plan was noncompliant. Consequently, the 44 percent of plans reported to have one or more instances of noncompliance is at best an upper bound on the extent of noncompliance found in this study. The questionnaire was not developed to specifically identify 401(k) plan noncompliance, and the answers were not validated as accurately demonstrating compliance or noncompliance. Some data that IRS collected were inconsistent or inaccurate, because the agents who completed the questionnaires did not conduct the audits or complete the questionnaires in a uniform manner. Additionally, although IRS audited a stratified random sample of 401(k) plans, it combined information in such a way that its reported findings could not be generalized to the broader population of all 401(k) plans. This is because IRS's data analysis did not use sample weights, which are necessary to make tabulations and other estimates when data are combined across plan sizes.[6]

IRS is currently planning and conducting research on several types of private pension plans to estimate prevalence and types of noncompliance. IRS has selected specific types of private pension plans—401(k) plans, sections 403(b) and 457 plans,[7] and multiemployer plans[8]—on which to

[6]A stratified sample divides a population into smaller groups, or strata, and draws a unique sample from each stratum. A researcher may sample a larger proportion of a particular stratum of interest to improve overall precision or to ensure that reliable estimates for that particular stratum can be made. When estimates about the entire population are to be made, such sample observations should be given less weight than observations selected from other strata. Because each sample observation from the stratum of interest represents fewer total elements of the population than do sample observations from other strata, combining sample observations without weighting them gives the stratum of interest more influence in the final answer than is indicated by its representation in the population. Thus, using weights in combining sample data is necessary to make tabulations and other estimates that can be generalized to a broader population.

[7]403(b) and 457 plans are authorized to include salary deferral arrangements under the Internal Revenue Code. Similar to 401(k) plans, these defined contribution plans permit participants to make tax-deferred contributions instead of receiving the same amount as taxable salary. Whereas 401(k) plans, during the years covered by the IRS study, were solely for private, for-profit employers, 403(b) plans are available to employers who are tax-exempt under Code section 501(c)(3) and public educational organizations and 457 plans are available to state or local governments or tax-exempt employers. (26 U.S.C. 403(b); 26 U.S.C. 457(g)).

[8]Multiemployer plans are provided for under the Internal Revenue Code. These plans are arrangements to which more than one employer is required to contribute and are maintained pursuant to one or more collective bargaining agreements between one or more employee organization(s) and more than one employer (26 U.S.C. 414(f)(1)).

conduct compliance research and will undertake studies similar in design to the one conducted on 401(k) pension plans for each of these plan types. The data that IRS collects will be analyzed to determine the prevalence and types of noncompliance among the plans studied. After implementing initiatives designed to improve the compliance of different plan types, IRS will conduct another compliance study and, by comparing results to the previous study, will determine the effectiveness of its initiatives. IRS officials told us that the agency is adopting lessons learned from its 1995 401(k) compliance study to enhance the quality and usefulness of future studies. For example, compliance planning groups, which involve key stakeholders from across the agency, have been assembled to assist in planning and designing specific compliance research studies. In addition, IRS told us that the questionnaires for upcoming 401(k) plan compliance studies will be pretested to determine the usefulness of the study questions in producing data on compliance and noncompliance.

IRS can take additional steps to ensure that the data it collects and the findings it reports are as accurate as possible. In this report, we make three recommendations to the Commissioner of the IRS to ensure the quality and usefulness of compliance studies, which in turn will enhance IRS's efforts to promote compliance among pension plan sponsors.

IRS provided written comments on a draft of this report and generally agreed with our findings, conclusions, and recommendations. IRS notes that it has incorporated our recommendations in a current compliance study on 401(k) plans. We agree that IRS has taken specific steps to improve its current 401(k) plan compliance study and describe these steps in our report. In addition to the current 401(k) study, IRS should also implement our recommendations throughout its current and upcoming compliance study initiatives on 401(k) and other types of pension plans.

Background

The IRC permits employers to sponsor defined contribution (DC) retirement plans and outlines requirements to which plan sponsors must adhere for tax-qualified status. With DC plans, employees have individual accounts to which employers, employees, or both make periodic contributions. DC plan benefits are based on the contributions to, and investment returns on, the individual accounts, and the employee bears the investment risk. In some types of DC plans, including 401(k), 403(b), and 457 plans and the Savings Incentive Match Plan for Employees

(SIMPLE), employees may choose to make tax-deferred contributions instead of receiving the same amount as taxable salary.[9]

IRS and the Pension and Welfare Benefits Administration (PWBA) of the Department of Labor are primarily responsible for enforcing laws related to private DC plans. Under the Employee Retirement Income Security Act (ERISA) of 1974, IRS and PWBA jointly enforce standards for coverage and participation, for vesting, and for funding that, respectively, determine how plan participants become eligible to participate in benefit plans, define how participants become eligible to earn rights to benefits, and ensure that plans have sufficient assets to pay promised benefits. IRS also enforces provisions of the IRC that apply to tax-qualified pension plans, including provisions under section 401(k) of the Code. PWBA enforces ERISA's reporting and disclosure provisions and fiduciary standards, which concern how pension plans should operate in the best interest of participants.

Since the IRS 401(k) plan compliance study was undertaken in 1995, various changes have occurred in certain legal requirements for tax-qualified status that IRS examined in the study. Certain requirements IRS examined in the 401(k) study are no longer applicable to tax-qualified DC plans or have been materially modified. Also, the IRC has since been amended to permit employers to adopt SIMPLE 401(k) plans and safe-harbor design methods for 401(k) plans. SIMPLE 401(k) plans and safe-harbor designs exempt 401(k) plan sponsors from certain rules that apply generally to 401(k) plans.[10] However, many of the statutory requirements that IRS examined in the 401(k) study have not changed materially. We were not able to assess the extent to which changes in relevant pension laws and 401(k) plan designs have affected the overall prevalence and incidence of noncompliance among the population of 401(k) plans (see app. II for more detail on changes in relevant pension laws since the study was published).

[9]Certain taxable or tax-exempt private employer with 100 or fewer employees may establish a SIMPLE plan (26 U.S.C. 408(p)).

[10]See the IRS 401(k) study publication for information on requirements for SIMPLE 401(k) plans and safe-harbor designs.

IRS groups violations of the IRC and corresponding regulations that must be satisfied to achieve tax-qualified status into four categories.[11]

- **Plan Document failure** occurs when the language of the plan documents does not comply with provisions of the tax Code.
- **Operational failure** occurs when the implementation and operation of a plan does not comply with provisions of the tax Code.
- **Demographic failure** occurs when a plan fails to comply with fundamental nondiscrimination requirements faced by all tax-qualified plans.[12]
- **Employer Eligibility failure** occurs when an employer that is not allowed to establish a section 401(k) plan, such as a state or local government, adopts such a plan.

IRS issued Revenue Procedure 2001-17 in February 2001 to establish its current framework for promoting the compliance of tax-qualified pension plans with the applicable requirements of the IRC. This framework has evolved since IRS first introduced voluntary compliance procedures in the early 1990s. To promote compliance, IRS developed the Self-Correction Program (SCP), the Voluntary Correction Program (VCP), and the Audit Correction Agreement Program (Audit CAP). SCP is used to correct insignificant Operational failures at any time, without fee or sanction and without IRS supervision.[13] VCP allows plan sponsors to voluntarily report and correct all types of qualification failures with IRS approval. Upon receiving IRS approval of the proposed correction measures, plan sponsors must implement the specified corrective measures and pay a compliance fee, one that is, on average, much less than the financial sanctions assessed for violations identified by IRS audits. The Audit CAP allows plan sponsors to correct all types of qualification failures that IRS identifies through formal audits. Under Audit CAP, plan sponsors must

[11] IRS also classifies compliance failures into three categories: *insignificant*, *significant*, and *egregious*. The IRS outlines seven primary criteria in Revenue Procedure 2001-17 for plan sponsors to determine whether or not a qualification failure is insignificant or significant. These terms generally apply to operational failures only.

[12] Nondiscrimination requirements stipulate that contributions or benefits must be apportioned in a nondiscriminatory manner between a top group of highly paid employees and owner-employees, and workers outside the top group (26 U.S.C. 401(a)(4), 401(a)(26), 410(b)). These provisions of the Code applied to 401(k) plans during the IRS study. (26 U.S.C. 401(a)(26) no longer applies to DC plans).

[13] Under SCP, pension plan sponsors may also voluntarily self-correct *significant* Operational failures within a limited time frame.

correct all qualification failures and pay a negotiated financial sanction commensurate with the nature, extent, and severity of the failures. If IRS and the plan sponsor do not reach an agreement with respect to the correction of the failure(s), IRS can pursue disqualification of the plan for tax purposes.[14]

All IRS audits of tax-qualified employer-sponsored plans are carried out under one of two audit programs, the Examination Program or the Compliance Research Program. The Examination Program includes a wide range of compliance-related activities. These activities include auditing based on referrals and computer targeting, training for IRS examiners who perform plan audits, and reviewing closed audit cases. The Compliance Research Program sponsors studies, such as the 401(k) study, to identify and monitor noncompliance among private plans. Compliance studies are based on plan audits, which IRS conducts so that it can collect study data. IRS is in various stages of planning and conducting compliance research on several types of private pensions, and intends to use data from these studies to develop more effective enforcement and compliance activities. However, plan audits conducted under the auspices of the Compliance Research Program represent a small proportion of IRS's total audit activity. In fiscal year 2001, IRS plans allocated a total of 1,845 staff days to audits for the Compliance Research Program, compared with 33,734 staff days allocated to audits for the Examination Program. For fiscal year 2002, IRS plans to increase the number of staff days related to compliance research activities, but direct examination activities will still constitute the majority of IRS's audit work.

Audits of employer pension plans are initiated when the IRS selects for audit a plan return, or form 5500 filing, from the Return Inventory Classification System. A notification letter is sent to the plan sponsor with a request for information that the examiner needs to complete the audit. IRS examiners complete a process that includes interviewing the plan benefits administrator, reviewing plan documents, and holding a closing conference to discuss the results of the audit with the plan sponsor. If an examiner finds a qualification issue, or a failure that can potentially disqualify a plan's tax-exempt status, the examiner can resolve the violation through correction under IRS's SCP (Self-Correction Program

[14]See U.S. General Accounting Office, *Pension Plans: IRS Programs for Resolving Deviations From Tax-Exemption Requirements*, GAO/GGD-00-169 (Washington, D.C.: August 14, 2000) for additional information on IRS compliance procedures.

disposal) or enter into a closing agreement with the plan sponsor through the Audit CAP (closing agreement disposal). Both of these audit disposal methods indicate that the examiner identified a violation that could potentially disqualify the plan, but the Audit CAP closing represents a more significant disposal than correction under the SCP.

IRS Audited a Sample of 401(k) Plans to Estimate Noncompliance

IRS audited a sample of 401(k) plans to collect data and estimate noncompliance with certain requirements of the Internal Revenue Code. IRS examiners were provided with a questionnaire to obtain information on the compliance of these 401(k) plans after conducting the audits. Once the data were gathered, IRS identified 73 study questions that could indicate whether or not a plan was in compliance. IRS data analyses produced estimates on the number of plans that failed to comply in one or more instances, based on the answers to these 73 compliance indicators. IRS's original estimates on noncompliance decreased after some adjustments were made to its initial analysis.

IRS Selected a Sample of 401(k) Plans to Audit

In selecting a sample of plans to study, IRS analyzed a database that it maintains on the population of tax-qualified plans. This database contains records of form 5500 returns that plan sponsors file with the IRS and Department of Labor, and IRS identified pension plans that had reported a 401(k) feature for the 1993 plan year. IRS identified 143,535 plans that reported a 401(k) plan feature, but excluded about 470 plans prior to sample selection, because these plans had no participants at the end of 1993 or had recently been audited by IRS. This step reduced the population to 142,768 401(k) plans from which IRS would select plans to study.

These remaining 401(k) plans were subdivided evenly by size into three groups labeled small, medium, and large plans. To create a sample of 525 plans, IRS randomly drew equal numbers of plans from these small, medium, and large categories. The method that IRS used to create the sample of 525 401(k) plans from these categories was basically equivalent to drawing a simple random sample in which each plan had an equal probability of selection. However, before drawing 175 plans from each of these three groups, IRS carved out the 25 largest plans from the large-plan category and put these plans into a separate group that it called "super-large plans"; this super large category was selected as a 100 percent sample of the largest 401(k) plans. Taken together, IRS's sampling method was intended to produce a representative sample from, and reliable results for, the 401(k) plan population. The sample of 550 plans was assigned to

IRS key district offices, where study coordinators were responsible for selecting the plan's 1994 form 5500 return and assigning the plan to an IRS examiner for audit.

Examiners Completed a Study Questionnaire after Auditing Plans

IRS examiners were provided a questionnaire to obtain information on the compliance of the 401(k) plans and were instructed to complete the questionnaire after auditing each plan in the study. IRS examiners' answers to the study questions were based on their plan audits. The questionnaire, or check sheet, that IRS used for its study was originally developed as part of a broad information-gathering project and included 254 questions to obtain information on 401(k) plan characteristics, design features, and compliance with certain requirements of the IRC. IRS used this available questionnaire to collect data relevant to its study objective of measuring 401(k) plan compliance. Once the study questionnaires were completed, they were sent to IRS Employee Plans headquarters for review and data analysis. Prior to its data analysis of 401(k) plan noncompliance, IRS reviewed all 550 questionnaires and excluded 78 of them from the analysis because the study questionnaire contained insufficient data or because the plan erroneously reported a 401(k) plan feature.

IRS Analysis of 401(k) Plan Noncompliance Based on Compliance Indicator Data

Once the data on the 472 remaining plans were gathered in Employee Plans headquarters, IRS analysts identified 73 out of the 254 questions on the questionnaire that they believed could indicate whether or not a plan was in compliance with certain requirements. That is, IRS identified the study questions it expected would provide information that a plan was either in compliance or not in compliance with certain requirements. These 73 "compliance indicators" became the focus of IRS's analysis in identifying and summarizing the prevalence and types of noncompliance among 401(k) plans. The study questions that related to compliance issues included a range of items concerning certain statutory requirements that apply to all qualified defined contribution plans and concerning legal requirements that apply to qualified 401(k) plans. For example, the compliance indicators that IRS analyzed included items concerning employer contribution requirements, coverage rules, nondiscrimination provisions, and limits on employee contributions in addition to other important rules and requirements that qualified plans must satisfy.

IRS data analyses identified the number of plans that failed to comply with one or more of their compliance indicators. The IRS study reported that 44 percent of the 472 plans remaining in the study had one or more instances of noncompliance with certain requirements that IRS examined; the other

56 percent of the plans were found to have no violations. These percentages varied slightly according to plan size category. The study reports that 41 percent of small plans, 47 percent of medium plans, and 44 percent of large and super-large plans had one or more instances of noncompliance.

IRS also used its noncompliance indicator data to estimate, by calculating the number of times specific violations were identified, the frequency with which these violations occurred in its study sample. IRS analyses counted 251 instances of noncompliance that it categorized by requirements to which tax-qualified 401(k) plans should adhere. In total, the study publication uses 16 categories, such as nondiscrimination, loans, coverage, vesting, and participation, to report on various types of noncompliance that IRS found among the 401(k) plans in the study.[15] For each of the compliance categories, the study publication reports the total number of violations that occurred. According to the study report, the total number of violations for each compliance category cannot be correlated to the number of plans containing these violations because some plans may have contained more than one violation within a category. As a result, the study publication does not show how many plans had more than one instance of noncompliance in a single category or how many plans had more than one type of compliance violation.

The analysis did not attempt to distinguish instances of noncompliance according to the severity of the violation. For the plans that had one or more instances of noncompliance, no study questions captured information on the insignificance or significance of the violations that IRS identified. Nor did the questionnaire include specific items on the number of participants (if any) affected and the amount of assets (if any) that were represented by the noncompliance errors IRS found. The questionnaire did contain items on the total number of plan participants and assets, but IRS did not analyze these data in relation to its findings on noncompliance.

With Supplemental Information, IRS Modified Original Findings

IRS's original estimates on 401(k) plan noncompliance decreased after IRS made some adjustments to its initial analysis of compliance indicator data. Initially, IRS used its noncompliance indicator data to produce estimates of 401(k) plan noncompliance. For some plans, however, IRS found

[15]See the study publication for the 16 compliance categories that IRS used and the total number of violations within each of these categories.

problems with the data for specific compliance indicators. During its analysis, IRS told us that it sometimes discovered instances in which data for certain compliance indicators were found to be either inaccurate or insufficient to determine whether an instance of noncompliance had occurred. However, IRS's discovery of discrepancies in the data was not the result of systematically reviewing all the compliance indicator data for each plan in the study. Instead, in some of these instances where IRS discovered problems with its compliance indicator data, these data were compared with information that IRS routinely captures about the results of their plan audits. According to IRS, analysts who worked on the data analysis met occasionally to review the data recorded on the study questionnaires and to determine whether the compliance study data were sufficient to identify noncompliance. After comparing the compliance indicator data with the other information that IRS collects on their audits of these 401(k) plans, the analysts made adjustments to the compliance indicator data. However, IRS analysts sometimes adjusted the data solely on the basis of their assessments that specific compliance indicators were not reliable or sufficient to determine whether or not a violation had occurred. Because these adjustments were not based on a systematic review of the accuracy and sufficiency of the data, we could not determine whether the adjustments that IRS made resolved all potential problems with its compliance indicator data.

These adjustments changed noncompliant plans to compliant, and vice versa. For example, IRS analysts determined that some 401(k) plans with at least one violation of certain nondiscrimination requirements were found to be fully compliant once the additional information was included in the analysis. Also, some plans that had been included in the original estimate of plans with no compliance errors were determined to have at least one instance of noncompliance when IRS used this extra information to inform its analysis.

When IRS used these adjustments to supplement the analyses it had performed, the total number of compliance violations decreased. At one point during its data analysis, IRS estimated that 298 total instances of noncompliance had occurred among the plans in the study. However, IRS's final estimate of the total number of compliance errors was revised downward to 251. As a result of these changes, IRS's estimate of the percentage of 401(k) plans with one or more instances of noncompliance decreased from 56 percent to 44 percent.

IRS Study Does Not Generally Provide Accurate Estimates of 401(k) Plan Noncompliance

The IRS study did not, in general, provide accurate estimates of the overall prevalence and types of noncompliance among 401(k) plans. IRS's estimates of noncompliance among 401(k) plans were inaccurate primarily because only 27 of the 73 questions that it identified as compliance indicators conclusively demonstrated a plan's noncompliance. Also, the reported findings could not be generalized to the broader population of all 401(k) plans because the analysis did not take into account the sample weights.

Fewer Than Half of the IRS Compliance Questions Conclusively Demonstrated Noncompliance

More than half of the study questions that IRS identified to analyze 401(k) plan compliance were unable to conclusively demonstrate noncompliance. We asked IRS analysts involved in the study's data analysis to evaluate the 73 questions that were selected as compliance indicators and determine whether these questions could definitively demonstrate a compliance violation. In evaluating each of the compliance indicators, IRS assessed whether the answers to these questions would provide information that was relevant to, or suggestive of, noncompliance or in fact demonstrated an instance of noncompliance. As a result of this evaluation, the IRS analysts identified only 27 questions that could definitively demonstrate noncompliance. In contrast, IRS determined that the remaining 46 questions were not sufficient by themselves to demonstrate noncompliance because potential problems rendered these indicators less conclusive. Although a positive response was generally sufficient to demonstrate compliance, the IRS analysts whom we spoke with told us that additional information would be needed to determine whether or not negative answers to these questions conclusively indicated noncompliance. Consequently, the 44 percent of plans reported to have one or more compliance violations is at best an upper-bound estimate of the extent of noncompliance found in this study because the reported results are not limited to those items with sufficient information to identify noncompliance.

IRS's compliance indicators were not initially developed to specifically identify and substantiate noncompliance among 401(k) plans and the answers were not validated as accurately demonstrating noncompliance. Instead of formulating study questions that were directly relevant and sufficient to demonstrate noncompliance, IRS used an already available questionnaire that had been developed as part of a broad information-gathering project. This broadly scoped research project had been revised to address the narrower objective of 401(k) plan compliance. Only after administering the check sheet and collecting the data did IRS identify the study questions that it expected to demonstrate noncompliance. As a result, most of the 254 questions on the questionnaire were not directly relevant to the study objective of estimating noncompliance among 401(k) plans. Also, some of the answers expected to demonstrate noncompliance from IRS's analysis of noncompliance indicator data were found to be suggestive, rather than demonstrative, of noncompliance. Although IRS, to help ensure ease in recording the answers, pretested the software that its examiners used to complete the study questionnaires, it did not pretest the study questions. Because IRS did not pretest the questionnaire for the accuracy and appropriateness of the answers, problems with the questionnaire were not identified or remedied before the data were collected. For example, answers might have more accurately reflected the types of information that were being sought if a preliminary evaluation and pretesting of the 73 compliance indicators had been used to improve the wording of the questions and the instructions provided to the examiners collecting the information.

We found that the accuracy of IRS estimates was also hampered by the lack of adequate training for examiners who filled out the study questionnaires after completing the audits. Each field office sent representatives to a kickoff conference that provided training for the 401(k) study. However, the training did not address which study questions would be used to distinguish compliance from noncompliance, because IRS identified these questions after the data were collected. Additionally, IRS told us that uniform audit standards were not developed to guide examiners in conducting the audits and in using the audit information to answer the study questions. As a result, an IRS analyst responsible for the data analysis stated that the 401(k) plan audits were not uniform and that some of the data were not collected consistently. Further, the representatives trained were not the examiners expected to conduct the audits and complete the subsequent questionnaires but rather the field office representatives charged with managing the local data collection efforts and transmitting data to headquarters for analysis. However, the field office representatives did not receive information regarding which questions would be used to distinguish compliance from noncompliance and thus could not relay this information to the auditing examiners.

Despite the discovery of inaccurate and inconsistent answers, IRS did not systematically verify the accuracy of all the data analyzed. Instead, the IRS analyst who summarized the study data told us that he made some judgmental corrections to obviously incorrect or inconsistent answers rather than ordering the relevant closed case file or contacting the relevant examiner to obtain valid and accurate answers. As a result, some answers to certain study questions were not used in IRS's final estimates of 401(k) plan noncompliance and others were used but judgmentally adjusted. In addition, the use of additional information to revise estimates of noncompliance was not well documented. We could not verify the revisions in IRS estimates, because IRS was not able to provide us with a single complete data file to check whether its reclassifications of plans as compliant or noncompliant were accurate. More complete documentation would have helped IRS ensure that it accurately estimated the proportion of plans that had one or more compliance errors and the frequency of occurrence for specific violations.

Reported Results Cannot Be Generalized to Broader 401(k) Plan Population

Not all of the IRS study findings could be generalized to the broader population of all 401(k) plans, a fact that makes them less useful. To the extent that findings were reported separately for the small, medium, large, or super-large groupings, these results are reliable estimates for compliance errors of all plans in such groups (other data issues notwithstanding). For example, the report estimates that 53 percent of the 162 medium plans audited had no violations. This figure can also be used as an estimate of the percentage of medium-size plans in the broader population that had no violations (other data issues notwithstanding). However, in cases where compliance information was aggregated to include results from more than one group, such results are not reliable estimates for compliance errors of other plans in these groups. IRS sampled all of the super-large 401(k) plans to ensure their inclusion in the study. Because the super-large plans were a 100 percent sample and the plans sampled in the other plan-size categories each represented about 1,000 plans from the total population, combining sample results for these groups without weighting them gives the super-large plans more influence in the final answer than is warranted by their representation in the total 401(k) plan population. Proper weighting of all sample cases is necessary to make tabulations and other estimates that can be generalized to the broader 401(k) population. In some cases, information from large and super-large plans was combined for reporting. In other cases, information was combined for all plans studied. For example, the report estimates that 56 percent of the 171 large and super-large plans studied had no compliance errors and that 56 percent of all 472 plans studied had no errors. In these cases where IRS has combined information for all plans in the study or for two plan-size categories, the reported percentages do not represent the percentages in the corresponding population of 401(k) plans. If IRS's analysis had accounted for its sampling methodology, it is possible that IRS would have produced estimates similar to the reported results of the 401(k) study because the reported estimates of the proportion of plans with one or more instances of noncompliance were similar across plan-size categories.

Furthermore, the 401(k) study findings cannot be used as estimates of noncompliance among the current population of 401(k) plans. To assess whether the 401(k) study results reflect the level and types of noncompliance among the current population of 401(k) plans, the data that support the published results would need further analysis to account for changes that have occurred in relevant pension laws since the study was undertaken. Although the 401(k) study publication describes changes to relevant pension laws that occurred during the course of the study, it is not possible to determine how these changes have affected noncompliance among 401(k) plans by simply examining the study findings. Also, changes have occurred in relevant pension laws since the study was published (see app. II for a description of changes in relevant pension laws since the study was published).

IRS Is Planning to Continue Compliance Research

IRS is currently planning and conducting research on several types of private pension plans to determine the prevalence and types of noncompliance. To obtain information on the extent and types of noncompliance among these plans, IRS plans to conduct compliance studies similar to the one conducted on 401(k) pension plans. After implementing initiatives to improve compliance, IRS plans to once again collect and analyze similar compliance data to determine the effectiveness of its initiatives. In its ongoing research efforts, IRS is adopting lessons from its prior compliance study.

Current Plans Include Compliance Study Initiatives on Several Types of Private Pensions

IRS is currently planning and conducting compliance research on several types of private pension plans. According to IRS officials who are involved in IRS enforcement and audit activities, compliance research will be used to help plan and implement initiatives that address compliance issues among various types of plans. IRS also told us that compliance research initiatives could be useful sources of information for plan sponsors and administrators, who are encouraged by IRS to use voluntary compliance procedures in identifying and remedying noncompliance. In addition, IRS uses this information to determine issues that are appropriate for published guidance. Ongoing compliance research is being conducted according to an overall strategy that IRS calls its market segment approach, developed to identify compliance issues among various types of tax-qualified pensions that employers sponsor. This market segment approach is being used by IRS to estimate the level and types of noncompliance among specific types of pension plans and to measure the impact of initiatives that IRS devises to address noncompliance. IRS has selected specific types of private plans for ongoing compliance research, including 401(k) plans, sections 403(b) and 457 plans, and multiemployer plans. IRS chose these plan types for several reasons, such as their prevalence, the significant degree of noncompliance known from past audits of these plan types, and/or the need to develop experience in conducting audits and compliance research. According to IRS, compliance studies for these plan types are in various stages of development and implementation. In the future, IRS plans to expand its compliance research and initiative development to other types of private plans.

IRS officials whom we spoke with said that these compliance studies will be similar in overall design to the prior 401(k) study. For the various plan types that IRS has identified, IRS will select plans to study through sampling or some other mechanism. A study questionnaire will be developed to capture information about compliance with certain requirements. IRS examiners will audit plans that have been selected for the study and will answer study questions on the basis of the audits. The data that IRS collects will be analyzed, and the results will be used to estimate the extent and types of noncompliance among the plans in these studies.

Study findings will be used by IRS as baseline information about noncompliance among the plan types selected for compliance research. After implementing initiatives designed to improve the compliance of the plan types that were selected for compliance research, IRS will conduct a follow-up compliance study to assess the impact of its compliance activities and specific initiatives. The follow-up studies will be designed to collect data that permit a comparison with baseline data from the initial studies of the level and types of noncompliance. IRS data analysis and examination of results from both the initial and follow-up studies will help IRS determine whether overall compliance has improved.

IRS staff told us that as the results of compliance studies become available, IRS will be able to make better assessments of how to use compliance study data. For example, IRS has conducted compliance research on 403(b) plans that it has used to develop specific outreach and education initiatives, including a Web site with information on noncompliance and speaking points for IRS examiners who meet with plan sponsors and administrators. In addition, IRS plans to use its compliance studies to improve the way it conducts audits. For example, IRS intends to use the results of compliance studies to develop more standardized audit guidelines and targeted audits to better identify compliance issues among, and to limit plan audits to those issues relevant to, specific types of plans.

Current IRS Compliance Research Initiatives Incorporate Lessons from Prior Study

IRS is adopting lessons learned from its prior compliance study to enhance the quality and usefulness of ongoing and future compliance research initiatives. Through our review of IRS work plans and interviews with IRS officials, we identified several aspects of current and future IRS compliance studies that are improvements on the prior 401(k) study. For example, IRS's current approach to planning compliance research has become more comprehensive. Unlike the 1995 401(k) study, IRS work plans indicate that "compliance planning groups" have been assembled for each of the four plan segments on which IRS is conducting compliance research. These groups, which include key stakeholders from across the agency with expertise in various aspects of pension plan compliance, are being used to help IRS formulate comprehensive plans for conducting upcoming compliance research. According to IRS officials whom we spoke with, IRS will obtain guidance and input from its Research and Analysis group to assist with the design and implementation of its compliance studies.

We identified other aspects of compliance studies, in addition to better planning, that improve on the prior 401(k) study. In conducting upcoming studies, IRS told us that it plans to develop and provide enhanced training for examiners who are responsible for auditing the plans and recording the study information. For example, IRS plans to conduct a training session for IRS examiners who will be assigned to conduct 401(k) plan audits for ongoing compliance research. IRS officials told us that examiners would receive training on the study questionnaires and in how to answer the study questions. In addition, part of the training that IRS intends to provide for 401(k) plan studies will be based on standardized guidelines that IRS has developed for collecting information from 401(k) plan audits. IRS has developed standardized audit guidelines for each of the plan types that the agency has selected for ongoing compliance research. According to IRS, these guidelines will help IRS examiners, including examiners involved in compliance studies, collect and record information consistently and accurately.

IRS told us that it intends to incorporate other improvements into its upcoming 401(k) plan compliance studies. For example, IRS said that examiners who participate in upcoming IRS compliance studies will have a role in developing the questionnaires used to collect compliance study data, and IRS will pretest compliance study questionnaires to help determine their usefulness and the accuracy of the information that they are intended to collect. Also, IRS is developing automated tools that its examiners will use to record answers to compliance study questions. Automated tools that IRS examiners can use to collect information during the course of an audit have been developed for the 401(k) plans but are still in development for other plan segments. According to IRS officials, these automated tools will help IRS produce work papers to document and verify its compliance study data.

Conclusions

Compliance research studies could play an integral role in IRS's efforts to ensure that tax-qualified pension plans adhere to applicable laws and regulations. The findings from such studies can provide data on the prevalence and types of noncompliance among pension plans, helping IRS shape its enforcement efforts. For example, IRS can use compliance study findings to identify key aspects of noncompliance among specific types of plans and develop targeted audits and other activities to address compliance issues. In recent years, IRS enforcement efforts have placed greater emphasis on voluntary correction procedures—that is, encouraging plan sponsors to correct violations that are discovered. Information on noncompliance that is useful and accurate could help improve targeting for audits and enhance voluntary compliance initiatives that assist plan sponsors in discovering and making such corrections. Compliance research can also measure the impact of such efforts to determine whether they are effective.

The more accurate the findings from compliance studies, the better able IRS is to ensure that plans are operating in accordance with applicable requirements, so that participants receive the coverage and benefits to which they are entitled. Compliance study findings can help IRS tailor its initiatives to identify, monitor, and address the most essential aspects of noncompliance among specific types of pension plans and measure whether its activities are effective in promoting compliance among plan sponsors. IRS recognizes the need to improve the way it conducts compliance studies and is in the process of implementing specific steps to improve aspects of planning and conducting these studies. Since IRS compliance research is focused on other types of plans besides 401(k) plans, it is important that IRS consistently implement these steps throughout its ongoing and future compliance research initiatives.

Several shortcomings of the 1995 IRS 401(k) study undercut its effectiveness in meeting IRS's research objective of estimating the extent and types of noncompliance among 401(k) plans. These shortcomings cut across important components of the 401(k) study, including questionnaire design, data collection, and data analysis. Whether these and other elements of research are designed and carried-out in a sound manner help determine the effectiveness of research studies in meeting their objectives. For example, the 1995 401(k) study questions were not pretested to determine whether they would have produced demonstrative data on noncompliance, and examiners who completed the study questionnaires were not provided with training on answering the questions in an accurate and uniform manner. To ensure the accuracy of its findings, IRS will need to build steps into its compliance studies that improve the accuracy and usefulness of the data that are collected, analyzed, and reported. Additionally, documenting a research study can help produce evidence that supports the answers to the research questions. Insufficient documentation limits the perceived accuracy and the usefulness of a research study.

Recommendations

To ensure the quality and usefulness of ongoing and future compliance studies in providing information that enhances IRS's efforts to promote compliance among private pension plans, IRS should take steps to improve how it conducts compliance study research. These steps, in addition to the agency's current efforts to improve the quality of compliance studies, should be incorporated into all planned compliance studies. Accordingly, we are making three recommendations to the IRS Commissioner for all future compliance studies.

We recommend that IRS pretest compliance study questionnaires to obtain information on the usefulness and accuracy of the answers in achieving IRS's research objective.

We also recommend that IRS provide uniform and comprehensive training to examiners who participate in compliance studies, so that they will know what information is needed to answer the study questions and can collect this information consistently and accurately.

Finally, we recommend that IRS maintain sufficient written or electronic documentation to enable it to validate and verify the results of compliance studies with evidence; this would allow IRS to explain the methods used to analyze study data and arrive at findings.

Agency Comments

We provided a draft of the report to the Commissioner of the IRS and the Department of the Treasury. IRS generally agreed with our findings, conclusions, and recommendations. In its letter, IRS notes that has incorporated our recommendations in a current compliance study on 401(k) plans. We agree that IRS has taken specific steps to improve its current 401(k) plan compliance study and describe these steps in our report. In addition to the current 401(k) study, IRS should also implement our recommendations throughout its current and upcoming compliance study initiatives on 401(k) and other types of pension plans. The IRS also provided us with technical comments, which we incorporated as appropriate. IRS's comments are included in Appendix III.

We are sending copies of this report to the Honorable Paul H. O'Neill, Secretary of the Treasury, the Honorable Charles O. Rossotti, Commissioner of the IRS, and other interested parties. We will also make copies available to others on request. If you or your staff have any questions concerning this report, please call me at (202) 512-7215. Key contributors are listed in appendix III.

Sincerely Yours,

Barbara D. Bovbjerg, Director
Education, Workforce, and
Income Security Issues

Appendix I: Scope and Methodology

Determining the Steps IRS Took to Conduct the 401(k) Study

To determine what IRS did to estimate the prevalence and types of 401(k) plan noncompliance with the requirements of the Internal Revenue Code, we reviewed the final 401(k) compliance study report that IRS posted to its Web site. In addition, we reviewed the initial and interim draft reports that we received from IRS, as well as study-related work papers, which documented the design, implementation, and analysis components of the study. We also interviewed IRS officials in the Employee Plans area of IRS's Tax Exempt and Government Entities Division, including officials in the Office of Examinations and the Office of Education and Outreach who were responsible for conducting and disseminating compliance research on private plans to obtain information about how IRS designed and conducted the study. Our work focused on identifying and summarizing the major components of the 401(k) study in relation to key elements of research study methodology including the study objective, study design, sample selection, questionnaire design, data collection, and data analysis.

Evaluating the IRS Study on the Prevalence and Types of Noncompliance among 401(k) Plans

Our evaluation of IRS's estimates of the prevalence and types of noncompliance was limited because IRS was unable to provide us with a complete data set or documentation that supports the final study results. As a result, we could not assess the usefulness of the study in relation to compliance among the broader population of 401(k) plans because we did not have data or other documentation that supported IRS estimates on specific types of noncompliance. Without this information, we could not make the appropriate sample weight adjustments to assess IRS estimates of the overall prevalence of noncompliance among all plans in the study or within specific plan size categories. Furthermore, the lack of a complete data set or comprehensive documentation supporting the published results limited our ability to reliably assess revisions in IRS estimates of the proportion of plans that had one or more compliance errors and the frequency with which specific types of errors occurred among the plans in the study. Additionally, the inability of IRS to provide closed case file information on audited plans limited our ability to assess the reliability of the data collected for analysis.

In light of these limitations, we elected to assess to what extent the IRS study provides accurate estimates on 401(k) plan noncompliance by evaluating, in relation to published guidance for conducting research, how the study was conducted. We evaluated the IRS study using a series of brochures on surveys published by the American Statistical Association

(ASA) and published GAO guidance on methodology and program evaluation.[1] These published guidelines address important elements of research studies, such as sampling and questionnaire design. Our evaluation examined and compared the sampling methodology, the questionnaire development, the data collection process, and the data analysis on which the IRS report is based with ASA and GAO guidelines on each of these elements. To examine and compare elements of the IRS study with published guidance, we collected and reviewed relevant documents such as draft study reports, the questionnaire check sheet, and other working papers made available by IRS. We also received and examined many electronic data files pertaining to the 401(k) study. Additionally, we interviewed IRS analysts who were responsible for conducting the data analysis and the IRS statistician who assisted with selecting the stratified random sample.

Describing IRS Plans for Compliance Research on Private Pensions

To describe IRS's current efforts in planning and conducting compliance research on private pension plans, we

- reviewed draft work plans for IRS's ongoing and future compliance research initiatives, including plans for an upcoming 401(k) plan compliance study;
- discussed lessons learned from the prior 401(k) study with IRS officials and analysts involved in compliance research initiatives;
- interviewed IRS officials in the Division of Tax Exempt and Government Entities, Employee Plans office to discuss the role of compliance research in IRS efforts to promote compliance among plan sponsors;
- reviewed official IRS guidance on agency procedures for identifying and remedying compliance violations; and
- discussed how compliance research initiatives can inform IRS' voluntary compliance activities with IRS officials.

[1] U.S. General Accounting Office, *Designing Evaluations*, GAO/PEMD-10.1.4 (Washington, D.C.: March 1991); *Developing and Using Questionnaires*, GAO/PEMD-10.1.7 (Washington, D.C.: October 1993); and *Using Structured Interviewing Techniques*, GAO/PEMD-10.1.5 (Washington, D.C.: July 1991).

We assessed IRS work plans and our discussions with IRS to identify and summarize the agency's overall plans for ongoing and future compliance research, including the role of compliance studies. As part of our work, we identified lessons learned from the previous 401(k) study that IRS has adopted in its plans to design and conduct compliance research initiatives.

Appendix II: Changes in the Laws That Govern Tax-Qualified 401(k) Plans

The IRS 401(k) study publication provides information on changes in relevant laws that occurred while the study was performed. The summary information that IRS includes in its published study report describes changes in relevant pension laws since the study was conducted and is pertinent up to the time at which the profile was posted on IRS Web site. This appendix summarizes and describes key changes in laws that apply to tax-qualified 401(k) plans that have occurred since the release of the published 401(k) study report, mostly changes arising from the Economic Growth and Tax Relief Reconciliation Act (EGTRRA)[1] as they relate to violation categories identified in the study. Our summary of recent changes in applicable laws is grouped by the compliance categories that IRS used to present its 401(k) study results.

Neither the IRS 401(k) study report nor this appendix should be regarded as a comprehensive explanation of the laws that relate to tax-qualified pension plans in general and tax-qualified 401(k) plans in particular. While this appendix provides context where necessary to understand how EGTRRA provisions change certain pension laws, it does not provide a history or complete description of the purpose and nature of the Internal Revenue Code (IRC) requirements that EGTRRA changes. The published 401(k) study report provides more in-depth description of the purpose and requirements of the specific IRC provisions that IRS examined as part of its 401(k) study.

A. Distributions Eligible For Rollover Treatment

EGTRRA section 636(b) mandates that any distribution made upon hardship of an employee will not be an eligible rollover distribution. Thus, no assets distributed to an employee on account of his or her hardship will be eligible for direct rollover to another plan or individual retirement account (IRA). Such distributions will therefore be subject to the withholding rules applicable to distributions that are not eligible rollover distributions.

Section 401(a)(31) of the Code provides that participants receiving an eligible rollover distribution must have the option to have the distribution transferred in the form of a direct rollover to another eligible retirement plan. If an eligible rollover distribution is not transferred by a direct

[1]P.L. 107-16, June 7, 2001.

rollover, the distribution is subject to withholding at a 20% rate, under section 3405(c)(1).

Regulations under section 401(k) currently provide that elective (pre-tax) deferrals under a 401(k) plan can, if the plan provides, be distributed (without earnings) in the event of the financial hardship of the employee. The regulations provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and the distribution is necessary to satisfy such financial need.[2] Under pre-EGTRRA law, hardship withdrawals of elective deferral amounts under 401(k) plans were not eligible for rollover, while other types of hardship distributions (e.g., employer matching contributions distributed on account of hardship) were eligible rollover distributions. Different withholding rules apply to eligible rollover distributions than to distributions that are not eligible rollover distributions.

EGTTRA section 641(c) also provides for an expanded explanation to recipients of rollover distributions. This provision requires that the rollover notice include a description of the provisions under which distributions from the eligible retirement plan receiving the distribution may be subject to restrictions and tax consequences which are different from those applicable to the plan making the distribution.

Effective for distributions after December 31, 2001, EGTRRA section 641 allows rollovers among 401(k) plans, 403(b) plans, or governmental section 457 plans. EGTRRA section 657 mandates that unless the participant elects otherwise, any eligible rollover distribution in excess of $1,000 that may be distributed without the participant's consent be automatically rolled over to a designated IRA. This change applies to distributions that occur after the Department of Labor issues final regulations implementing section 657.

Section 642(a) of EGTRRA provides that an eligible rollover distribution from an IRA may be rolled over to another IRA or an eligible retirement plan as long as the amount is transferred no later than 60 days after the date the distribution was received.

[2] 26 CFR § 1.401(k) – 1(d).

Section 642(b)(3) of EGTRRA provides that a distribution from a Savings Incentive Match Plan for Employees (SIMPLE) IRA may also be rolled over to another SIMPLE IRA.

Under pre-EGTRRA law, elective (pre-tax) deferrals may not be distributed earlier than one of the events described in section 401(k)(2)(B) or section 401(k)(10). EGTRRA modifies these rules as they apply in the case of a corporate transaction, such as an asset or stock sale, that results in employees of the seller going to work for the buyer. Pre-EGTRRA law permits distribution in the case of certain types of transactions but not others. EGTRRA section 646 amends section 401(k)(2)(B) by replacing "separation from service" with the more lenient standard of "severance from employment." This generally will permit distributions to employees who move from seller to buyer in connection with a corporate transaction, unless corresponding assets of the seller's plan move as well. Section 646 of EGTRRA also makes conforming changes to section 401(k)(10). The amendments made by section 646 apply to distributions made after December 31, 2001.

B. Nondiscrimination (ADP/ACP)

EGTRRA section 666 repeals the multiple use test effective for plan years beginning after December 31, 2001.

The multiple use test occurs where a 401(k) plan is subject to both the ADP and ACP tests and both tests can only be satisfied using the alternative limitations of those tests described under section 401(k)(3) and section 401(m)(2) (the 2 percentage point limit or the 200 percent limit). The purpose of the multiple use test is to prevent the multiple use of the more generous alternatives for meeting both the ACP and the ADP test when certain employees are eligible under both a section 401(k) plan and a section 401(m) plan.

C. Loans

EGTRRA section 612 repeals the rule prohibiting loans to sole proprietors, partners who own more than 10% of the partnership, and shareholders of S corporations who own more than 5% of the S corporation effective for years beginning after December 31, 2001.

D. Contingent Benefits – No change.

E. Hardship Distributions

EGTRRA section 636(a) directs that the regulations under section 401(k) be revised to permit a participant who receives a hardship distribution to resume elective (pre-tax) deferrals 6 months, instead of 12 months, after receiving a hardship distribution. This change is effective for years beginning after December 31, 2001.

F. Top-Heavy Requirements

EGTRRA section 613 generally simplifies several elements of top-heavy testing and their application. First, it simplifies the definition of key employee, so that the term includes only individuals who during the year in question or the immediately preceding year were officers earning over $130,000 (adjusted for cost of living increases), 5% owners, or 1% owners earning more than $150,000. Second, it specifies that in determining whether or not a plan is top heavy, only distributions made within the preceding 1 year, rather than the preceding 5 years (except for in-service distributions, for which the 5-year rule will continue to apply) must be added. Third, it requires that matching contributions to a top-heavy plan be counted in determining whether nonkey employees have received the required minimum benefit. Last, it states that certain plans meeting safe-harbor requirements applicable to the nondiscrimination rules regarding 401(k) and matching contributions will automatically be deemed to not be top heavy, and frozen defined benefit plans (with respect to which there are no current benefit accruals for current or former key employees) will be exempt from certain of the minimum accrual requirements. The new rules are effective for years beginning after December 31, 2001.

G. Coverage – EGTRRA section 664 directs that the regulations under Code section 410(b) be revised to allow a 401(k) plan to treat as excludable employees the employees of a Code Section 501(c)(3) entity who are eligible for a Code section 403(b) arrangement provided that: (1) no employee of the 501(c)(3) entity is eligible to participate in a 401(k) plan; and (2) at least 95 percent of the employees who are not employees of the 501(c)(3) entity are eligible to participate in the 401(k) plan. This change is effective January 1, 1997.

H. Section 415

Under EGTRRA section 611, the $35,000 limit on combined employer and employee contributions for defined contribution plans is raised to $40,000 (indexed for the cost of living in $1,000 increments). The 25% of compensation limit is increased to 100% of compensation. Therefore, the new 415(c) limit will be the lesser of (1) 100% of compensation or (2) $40,000 (adjusted for cost of living increases). This provision is effective for years beginning after December 31, 2001. Catch-up contributions are not taken into account in applying the $40,000 limit.

Section 611(d) of EGTRRA also increases the limit on elective contribution under Code section 402(g) from $10,500 in 2001 to $11,000 in 2002; $12,000 in 2003; $13,000 in 2004; $14,000 in 2005; and $15,000 in 2006. The limit is adjusted for increases in the cost of living for years after 2006 in $500 increments.

Section 631 of EGTRRA amends Code section 414 and provides that the otherwise applicable dollar limit on elective deferrals under a 401(k) plan, 403(b) plan, SEP, or SIMPLE plan, or deferrals under a governmental 457 plan will be increased for individuals who have attained age 50 before the end of the plan year, and who have otherwise already made the maximum permitted deferral under the Code or the plan or arrangement. The additional or "catch-up" contribution amount under a 401(k) plan, 403(b) plan or 457 plan is $1,000 for 2002, $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and thereafter. The limit is adjusted for cost of living increases for years after 2006 in $500 increments. These additional contributions are for individuals who are age 50 and or older and such contributions will not violate the nondiscrimination, top-heavy or 415 requirements.

Under Code section 401(a)(17), for years beginning after December 31, 2001, the amount of compensation that may be taken into account under a 401(k) plan is also increased from $150,000 (adjusted for cost of living increases to $170,000 in 2001) to $200,000. This limit is adjusted for cost of living increases in $5,000 increments.

I. Nondiscrimination under Section 401(a)(4) – No change.

J. Vesting

Under EGTRA section 633, employer matching contributions must vest at least as rapidly as under one of two new vesting schedules. These schedules provide for faster vesting than the current schedules. The first schedule requires 100% vesting after three years of service and the second requires 20% vesting after two years of service with an additional 20% vesting for each year of service, reaching 100% vesting after six years of service. This provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to collective bargaining agreements.

K. Prohibited Transactions – No change.

L. Plan Asset Rule

EGTRRA section 655 modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of eligible individual account plan by providing that the rule does not apply to any elective deferral which is invested in qualifying employer securities, qualifying employer real property, or both acquired before January 1, 1999.

M. Partnership Issues – No change.

N. Participation – No change.

O. Miscellaneous Limits – Under the Taxpayer Relief Act of 1997,[3] the former 15% tax on excess distributions and the 15% estate tax on excess retirement accumulations from qualified retirement plans, tax-sheltered annuities, and individual retirement arrangements is repealed.

P. Miscellaneous Violations – No change.

[3]P.L. 105-34 § 1073.

Appendix III: Comments from the Internal Revenue Service

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

COMMISSIONER

April 4, 2002

Ms. Barbara D. Bovbjerg
Director, Education, Workforce
and Income Security Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Ms. Bovbjerg:

We reviewed your draft report on the quality and usefulness of our compliance studies. We find that it fairly and accurately describes our efforts to conduct a compliance study of IRC 401(k) plans. While the report focuses on some of the deficiencies of our previous study, we have learned many lessons from this study that will help us improve future compliance studies.

We have already implemented your recommendations on improving compliance initiatives in our current compliance study of IRC 401(k) plans. We are conducting a pilot training class and examination initiative to test automated workpapers that will allow us to more consistently conduct examinations of IRC 401(k) plans. The automated workpapers will also allow us to electronically store certain examination results that will help validate the results of the compliance study. We will also test a compliance questionnaire as part of the pilot. We plan to conduct a comprehensive IRC 401(k) study in the future, after we complete this pilot project.

I would like to clarify your statement on page 4 of the report that indicates we are currently conducting a compliance study of the "plans of large corporations." We are not conducting a "study" of these plans. Rather, as part of the IRS redesign efforts, a Phase III Modernization Redesign Team proposed establishing an Employee Plans Team Audit (EPTA) program. The TEGE Implementation Steering Committee approved this program to address the compliance of the large plans that affect over 65% of all plan participants and over 65% of plan assets.

2

Thank you again for the opportunity to respond to your report. If you have any questions or concerns, please contact Carol Gold, Director of Employee Plans, Tax Exempt and Government Entities Division at (202) 283-2100.

Sincerely,

Charles O. Rossotti

Charles O. Rossotti

Appendix IV: GAO Contacts and Staff Acknowledgments

GAO Contacts

Barbara D. Bovbjerg, (202) 512-7215
George A. Scott, (202) 512-5932

Staff Acknowledgments

In addition to those named above, Jeremy Citro, Gene Kuehneman, Ed Nannenhorn, Corinna Nicolaou, and Roger Thomas made key contributions to this report.

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