

**Opportunities Exist for the Employee
Plans Function to Improve the Timeliness and
Accuracy of Merit Closure Determination
Letters**

August 2005

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 25, 2005

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT
ENTITIES DIVISION

A handwritten signature in black ink, appearing to read "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report - Opportunities Exist for the Employee Plans
Function to Improve the Timeliness and Accuracy of Merit
Closure Determination Letters (Audit # 200410013)

This report presents the results of our review of the process followed in the technical screening centers for determination applications closed on merit. The overall objective of this review was to determine whether the Employee Plans (EP) function's determination process for merit closures ensured determination letter applications were timely and consistently processed in accordance with procedures and provided quality service to customers.

The Tax Exempt and Government Entities (TE/GE) Division EP function is responsible for administering provisions of the Internal Revenue Code (I.R.C.) for more than 700,000 qualified pension plans with approximately 111 million individual participants and assets totaling more than \$4 trillion. Many employers desire advance assurance that the terms of their plans satisfy the requirements of the I.R.C. and will submit an application to the Internal Revenue Service (IRS) for a determination letter. EP function specialists analyze the applications to determine if the plans are established in a manner that meets current laws and are substantially compliant with the I.R.C. and any applicable Revenue Procedures. If all issues can be resolved within a limited time, usually within 30 calendar days, the application is closed on merit (i.e., a merit closure) and the EP function issues a favorable determination letter, which affirms the plan is entitled to favorable tax treatment as long as the plan is operated under the terms in the determination letter.

In summary, sufficient research was conducted to assess the qualified status of determination applications, but controls were insufficient to manage the significant increase in application receipts. EP function management established standard

processes for reviewing determination applications at the technical screening centers. Specifically, EP function specialists follow a standardized control sheet for performing research and determining whether plans have been established in compliance with the I.R.C. If a plan is determined to be in compliance, the specialist prepares a favorable determination letter using an automated system for generating letters. While these standardized processes were useful for reviewing applications, the processes need to be further developed and consistently implemented. For example, there were no standardized procedures for contacting plan sponsors when additional information was needed or for resolving applications when a response to a contact was not received. Instead, the EP function relied upon group managers and local procedures at the different technical screening centers to determine how often EP function specialists should contact plan sponsors and how to resolve the applications when no response was received from plan sponsors. As a result, significant inconsistencies existed in the processing of applications requiring customer contact.

In addition, the large increase in determination applications received because of the latest remedial amendment period¹ significantly delayed the processing of applications. As a result, the technical screening centers did not meet timeliness standards for processing applications. We identified several reasons for this. The EP function did not have sufficient information to track the processing of determination applications in the technical screening centers and had not established realistic and achievable timeliness goals for processing applications using merit closure processes. Moreover, the EP function's customer satisfaction surveys did not include a sample of customers with whom contact was required to resolve the applications. We also concluded improvements are needed in (1) the procedures for contacting plan sponsors to increase assurances that the level of service provided to customers is not dependent upon the technical screening center that processes the application and (2) the process for monitoring aged applications to make it more consistent with the processing goals of the EP function.

We found quality assurance reviews have surfaced ongoing problems with the accuracy of determination letters. For the past 3 fiscal years (Fiscal Years (FY) 2002 through 2004), the EP Quality Assurance function has reported error rates of 17 percent, 22 percent, and 15 percent, respectively, for determination letters issued by technical screening centers. Because the quality of determination letters has been a continuing problem, EP function management initiated a peer review process in FY 2003 that was designed to improve quality. If the peer reviewers identify errors, the determination letters are returned to the technical specialists for correction. While the peer review process may have helped reduce the error rate for determination letters in FY 2004, it has not been effective in reducing the error rate to an acceptable level. We identified several inconsistencies and potential weaknesses in the peer review process.

¹ The IRS allows plan sponsors time, called the remedial amendment period, to incorporate tax law changes without a penalty or sanction. The end of the remedial amendment period becomes the deadline for timely filing a determination letter application on the changes to the plan. The most recent remedial amendment period was scheduled to end on December 31, 2001, but was extended several times to January 31, 2004.

For instance, Determinations program group managers had different standards for selecting applications to be included in the peer review process as well as different standards for selecting employees to perform the reviews. In addition, peer review results for individual groups were not always being tracked and analyzed to improve error trends.

We recommended the Director, EP, establish a process that will set a more realistic, achievable timeliness goal for merit closures based on anticipated receipts for the year. We also recommended the Director, EP Rulings and Agreements, develop monitoring systems to effectively track merit closures and ensure a screening handbook being revised includes procedures for contacting plan sponsors when additional information is needed and for resolving applications when no response is received. In addition, we recommended the Director, EP Rulings and Agreements, revise processes designed to improve the quality of determination letters.

Management's Response: EP management generally agreed with the recommendations presented. The FY 2005 timeliness goal was modified in the Business Performance Review report to more realistically reflect current experience and the goal setting process will be revisited during the development of the FY 2006 Work Plan. The TE/GE Division will complete the baseline requirements for the Tax Exempt Determination System Release 2 Business Objects implementation to include reporting of average cycle time per screening center.

The TE/GE Division believes that including the results of applications that require customer contact in the performance measure for technical screening of applications that do not require customer contact will dilute the accuracy of the measure. Instead, the reporting of cycle time for applications requiring customer contact will be included in the baseline requirements for TEDS Release 2 Business Objects. We agree with management's alternative corrective action.

A Request for Information Services has been submitted to sample merit closures requiring customer contact as part of the customer survey process. Although TE/GE Division management does not believe the 30 day Tax Exempt Quality Measurement System benchmark would be helpful for monitoring screening timeliness because it was designed to measure the "perfect" merit closure without customer contact, they will revisit the time frame when the staggered remedial amendment process becomes effective for individually designed plans. The screening handbook being revised will include procedures for contacting plan sponsors and converting a case to a determination review if no response is received to enhance consistency among screening centers. The Manager, EP Determinations, mandated that all groups perform a 100 percent peer review of merit closure cases to ensure the accuracy of favorable determination letters and that group managers gather and share results with specialists. Management's complete response to the draft report is included in Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have any questions or

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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Opportunities Exist for the Employee Plans Function to Improve the Timeliness and Accuracy of Merit Closure Determination Letters

Background

The Tax Exempt and Government Entities (TE/GE) Division Employee Plans (EP) function is responsible for administering provisions of the Internal Revenue Code (I.R.C.) for more than 700,000 qualified pension plans with approximately 111 million individual participants and assets totaling more than \$4 trillion.

Pension plans must comply with pension laws and regulations that are highly complex to qualify for favorable tax-exempt status. Examples of favorable tax treatment for employers include:

- The assets and income of the plan are exempt from Federal taxes.
- Contributions to and expenses incurred by the plan are deductible.
- Participants are not taxed on their benefits until distributions are received from the plan.

Many employers desire advance assurance that the terms of their plans satisfy the requirements of the I.R.C. and will submit an application to the Internal Revenue Service (IRS) for a determination letter. If plans are established in accordance with I.R.C. 401(a),¹ the EP function issues a favorable determination letter, which affirms the plan is entitled to favorable tax treatment as long as the plan is operated under the terms in the determination letter.

A favorable determination letter may no longer apply if there is a change in a statute, regulation, or revenue ruling applicable to pension plans. When this occurs, the plan must be amended to comply with the new requirements. The IRS allows plan sponsors time, called the remedial amendment period, to incorporate tax law changes without a penalty or sanction. The end of the remedial amendment period becomes the deadline for timely filing a determination letter application on the changes to the plan. The most recent remedial amendment period was scheduled to end on December 31, 2001, but was extended several times to January 31, 2004.

¹ I.R.C. § 401 (a) (2005).

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Determination letter applications are submitted to the Cincinnati Campus² of the Small Business/Self-Employed Division of the IRS located in Covington, Kentucky. Prior to technical screening, applications are recorded on an inventory control system and sent to the EP function in Cincinnati, Ohio, where EP function specialists sort applications that will require a full-scope review (for the more complex plans) from those that may need only a limited-scope review by a technical screening center (for the lower-risk plans).

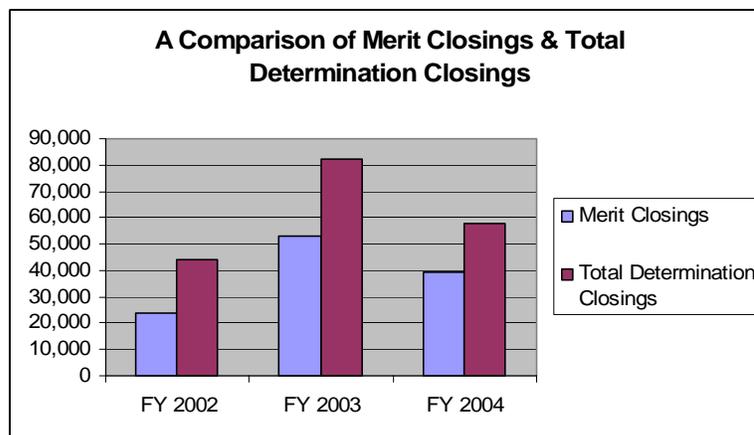
At the six technical screening centers, EP function specialists review the applications to determine whether they represent a low risk of noncompliance or do not require a full-scope review. Low-risk applications include those received from plan sponsors who have similar plans that were already approved by the EP function.

The EP function specialists then analyze the applications to determine if the plans are established in a manner that meets current laws and are substantially compliant with the I.R.C. and any applicable Revenue Procedures. During this process, the EP function specialist can fax or call the plan sponsor representative for additional information. If all issues can be resolved within a limited time, usually within 30 calendar days, a favorable determination letter is sent to the plan sponsor and the application is closed on merit (i.e., a merit closure). If an application requires further review because unresolved or complex issues have been identified, the technical screening centers may reassign it for a more detailed review (i.e., a nonmerit closure). In Fiscal Year (FY) 2004, the EP function closed a total of 57,950 applications, which included 39,370 (67.9 percent) merit closings and 18,580 (32.1 percent) nonmerit closings. As shown in Figure 1, for the past 3 fiscal years, a large majority of the determination applications have been closed on merit.

² Campuses are the data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

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Figure 1: A Comparison of Merit Closings vs. Total Determination Closings for FYs 2002 – 2004



Source: EP function determinations Electronic Determination System (EDS) statistics reports (FYs 2002 – 2004).

This review was performed at the Employee Plans function determination technical screening centers located in Cincinnati, Ohio; Baltimore, Maryland; and El Monte, California, during the period April through December 2004. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Sufficient Research Was Conducted to Assess the Qualified Status of Determination Applications, but Controls Were Insufficient to Manage a Significant Increase in Application Receipts

Based on our review of the process followed in the technical screening centers for determination applications closed on merit and EP function Quality Review reports, we determined EP function specialists conducted sufficient research to assess whether the applications qualified for tax-exempt status. The EP function Quality Review reports showed that, for FY 2004, 92 percent of the technical screening center applications did not require additional research before they could be closed on merit. The FY 2003 report showed a similar rate of 91 percent. However, the FY 2004 Quality Review report also showed a 15 percent error rate for determination letters. Although this error rate was less than those for the prior 2 fiscal years and EP function management has taken action to attempt to improve the quality of determination letters, additional improvements are needed to ensure favorable determination letters are

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accurately prepared. The latter issue is presented in more detail further in the report.

EP function management established standard processes for reviewing determination applications at the technical screening centers. Specifically, EP function specialists in the technical screening centers follow a standardized control sheet for performing research and determining whether plans have been established in compliance with the I.R.C. The control sheet includes:

- A list of alert guidelines to notify specialists of special circumstances that may need to be considered when evaluating an application.
- Core qualification issues, such as prior law compliance, eligibility, allocation or benefit formulas, and vesting schedules that the specialists need to consider before closing applications on merit.
- Recent law changes that could affect whether plans qualify for tax-exempt status.

The results of the specialists' analyses are recorded on the control sheet. This includes the decision whether to close the application on merit or assign it for further research as a nonmerit determination application. The control sheet is also used to explain how the plan met the current or any prior remedial amendment period by requiring the specialists to record the date the plan sponsor amended the plan.

If a plan is determined to be in compliance, the specialist prepares a favorable determination letter using an automated system for generating letters. The letters consist of standard paragraphs and selective paragraphs, which have all been programmed into the system. Selective paragraphs are added to address special situations, such as I.R.C. provisions that affect only one type of plan or additional requirements for terminating a plan. Some selective paragraphs are printed in the body of the letter; others are printed as an enclosure to the determination letter. After the specialist prepares the letter on the system, the application is routed to a clerk who mails the determination letter and closes the application on the inventory system.

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While these standardized processes were useful for reviewing applications, the processes need to be further developed and consistently implemented. For example, there were no standardized procedures for contacting plan sponsors when additional information was needed or for resolving applications when a response to a contact was not received. Instead, the EP function relied upon group managers and local procedures at the different technical screening centers to determine how often EP function specialists should contact plan sponsors and how to resolve the applications when no responses were received from the plan sponsors. As a result, significant inconsistencies existed in the processing of applications requiring contact with the customers.

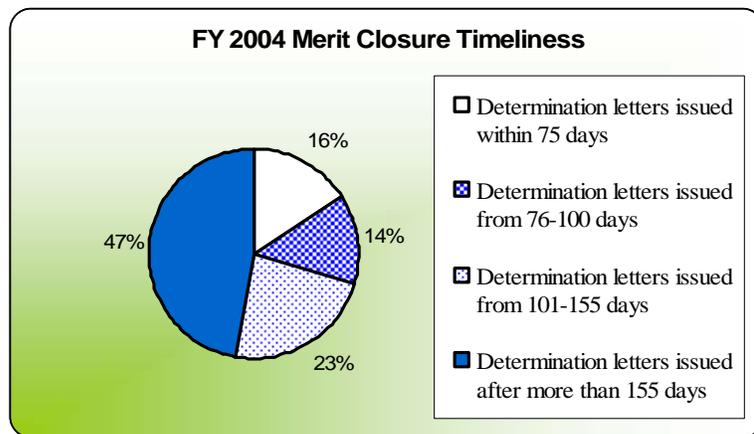
In addition, the large increase in determination applications received as a result of the latest remedial amendment period significantly delayed the processing of applications. As a result, the technical screening centers did not meet timeliness standards for processing applications.

The EP function performance goal for processing applications using merit closure procedures was 75 calendar days in FY 2004. However, the average number of days for processing applications using merit closure procedures was 152 days, which is approximately double the business performance goal.

As shown in Figure 2, based on EP function FY 2004 reports, the majority of determination applications closed on merit took longer than 75 days to process, with almost one-half taking longer than 155 days.

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Figure 2: Merit Closure FY 2004 Timeliness Results



Source: EP function EDS Closed Case Report.

Significant delays in processing determination applications can be a burden on customers. The timeliness becomes more important for those plan sponsors who made changes to ongoing pension plans, such as those who submitted applications during a remedial amendment period. Prompt merit closure determination letters enable plan sponsors to quickly verify the qualified status of their plans and to have the assurance that further corrections are not necessary.

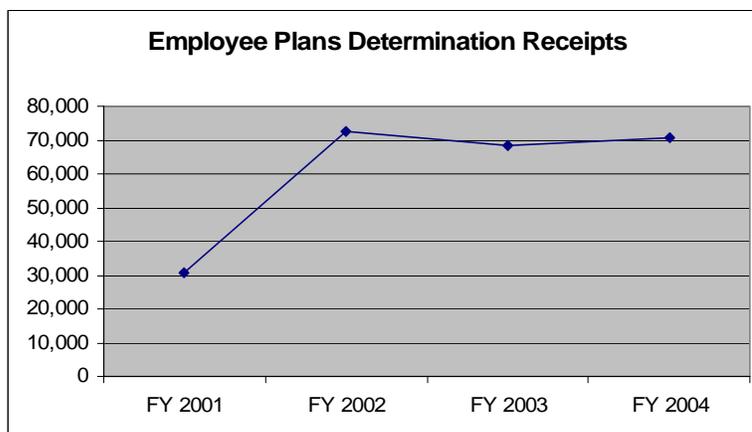
We identified several reasons why the EP function was unable to meet the FY 2004 cycle-time standard for processing determination letter applications using merit closure procedures.

The remedial amendment period caused a large increase in determination application receipts

In years that do not involve a remedial amendment deadline, the EP function expects to receive approximately 30,000 determination applications. With a remedial amendment, the EP function expects to receive significantly more. Figure 3 shows the increase in total determination applications received from FY 2001 (the year before the first deadline for the remedial amendment period) to the 3 years of the extended remedial amendment period, FYs 2002 to 2004.

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Figure 3: EP Function Determination Receipts for FYs 2001 – 2004



Source: EP function EDS statistics reports and TE/GE Division Business Performance Review.

However, although applications substantially increased, resources devoted to the total Determinations program (both technical screening centers and EP Determinations program groups) did not have a corresponding increase. For example, the EP function used 141 Full-Time Equivalents (FTE)³ to process all the determination applications in FY 2002, 191 FTEs in FY 2003, and 103 in FY 2004. The drop in resources applied to the EP Determinations program in FY 2004 was the result of a decision by EP function management to realign workgroups into separate Determinations and Examinations programs. Prior to FY 2004, Examinations program employees often worked determination applications in addition to examination cases.

The FY 2005 EP Work Plan stated that backlogs for processing determination applications using technical screening procedures caused delays for approximately 140,000 applications received during FYs 2003 and 2004. Backlogs of applications waiting to be processed in the

³ Since some employees are assigned to different program areas throughout the fiscal year, time used to process determination applications was converted to FTEs. An FTE represents the amount of time charged to the program by one employee working full time. It is a measure of labor hours in which 1 FTE is equal to 8 hours multiplied by the number of compensable days in a particular fiscal year. For FY 2003, 1 FTE was equal to 2,088 staff hours. For FY 2004, 1 FTE was equal to 2,096 staff hours.

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technical screening centers were expected to continue into FY 2005 and eventually decrease to a more stable workload. As of the beginning of FY 2005, there were 29,527 determination applications in the EP function's inventory, including 25,760 that had not yet been assigned to a technical screener for review.

The remedial amendment period ending in January 2004 was the fourth since the inception of the Employee Retirement Income Security Act of 1974.⁴ The EP function also had significant increases in determination application receipts as a result of remedial amendment periods in 1978, 1986, and 1995. EP function management has recognized the need to address the fluctuating receipt of determination applications for the future. EP function management plans to use a staggered approach to remedial amendment periods beginning in FY 2005 to stabilize the flow of receipts for determination applications.

The next section of the report will show that the large increase in application receipts during the remedial amendment period was a significant factor in the increased number of days required to complete technical screening processing.

The EP function did not establish realistic and achievable timeliness goals for processing applications using technical screening processes

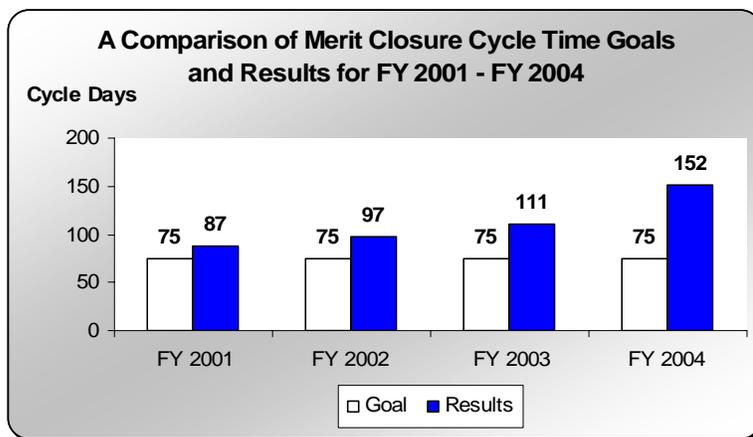
Work Plans in the EP function are developed to assist in guiding the organization toward established goals and objectives. From FYs 2001 through 2004, the EP function business performance goal presented in the Work Plans for merit closures remained at 75 cycle days.⁵ However, as shown in Figure 4, the actual number of days to close a merit closure steadily increased from 87 cycle days in FY 2001 to 152 cycle days in FY 2004.

⁴ Pub. L. No. 93-406, 88 Stat. 829 (codified as amended in scattered sections of 5 U.S.C., 18 U.S.C., 26 U.S.C., 29 U.S.C., and 42 U.S.C.). The Act set uniform minimum standards to assure that employee benefit plans are established and maintained in a fair and financially sound manner.

⁵ Cycle days are computed from the application's postmark date to the closing of the application and issuance of the determination letter.

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Figure 4: Merit Closure Business Performance Goals and Results for FYs 2001 – 2004



Source: EP Work Plans for FYs 2001 – 2005.

Although the cycle time goals remained constant during the remedial amendment period, the EP function was notifying customers that their determination letters could take much longer. The EP function sends an Acknowledgment Notice (Notice 3336) upon receipt of a determination application to advise plan sponsors that their determination applications were received. EP function management advised us that, prior to April 2000 and before the remedial amendment deadline, the notices included a statement that plan sponsors should normally expect to hear from the EP function within 145 calendar days. In addition, the EP Determination Letter Resource Guide on the TE/GE Division web site at the time of our audit instructed plan sponsors to wait at least 145 days before contacting the Employee Plans Customer Account Services call site for assistance in verifying the status of their determination letter applications. The actual cycle times during FY 2004 were slightly higher. As indicated in Figure 2 earlier, 47 percent of the merit closures took more than 155 days to process, with the majority taking more than 180 days to process. This meant some plan sponsors had to wait over 6 months for their determination letters.

The EP function needs to establish realistic and achievable timeliness goals for processing applications using technical screening processes. By establishing realistic goals, the EP function can more effectively manage workload against the goals. For example, while EP function management had

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expected a substantial increase in the receipt of determination applications, the timeliness goal for processing determination applications in the technical screening centers was not adjusted. In addition, EP function management had not developed procedures to update their estimated completion time during periods of high receipts when their original estimates were no longer achievable. Further, the estimates communicated to plan sponsors were not realistic. As a result, plan sponsors may have had an increased burden inquiring about the status of their applications, and the TE/GE Division Customer Account Services call site may have received more inquiries regarding the status of determination applications. The TE/GE Division Customer Account Services call site received 4,559 telephone calls on the status of EP function determination applications in FY 2004.

The EP function needs better information for tracking determination applications processed in the technical screening centers

EP function management did not have sufficient information to track the processing of determination applications in the technical screening centers. We identified several management information weaknesses that have limited EP function management's ability to monitor and report business results for technical screening center inventories. Correcting these weaknesses will enable the EP function to better track the timeliness of applications processed by the technical screening centers, evaluate business results, and provide sufficient oversight of all merit closures. These weaknesses include:

- A lack of information to monitor cycle-time information at the individual technical screening centers.

The EP function tracks the technical screening centers' timeliness by measuring the average number of days to process a determination application against the merit closure business performance measure goal. However, this information is shown only for the total applications processed by all six screening centers and is not broken down by the individual screening centers that were established at

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the beginning of FY 2004. The EP function reorganized workgroups and reassigned more than 90 EP Examinations program employees to the EP Rulings and Agreements office in Cincinnati, Ohio. The reassignment caused technical screening applications processed by the technical screening centers outside of Cincinnati to be shown on management information reports as having been processed by the Cincinnati screening center. As a result, EP function management does not have data to show whether the timeliness problems from FY 2004 were occurring across the board in all centers or in just one or two.

- An ineffective process for monitoring technical screening applications that require contact with customers.

Before October 2002, merit closure cases requiring customer contact were not easily identifiable on the EP function's inventory control system. In October 2002, the EP function developed a unique closing code for these types of merit closures. However, the EP function is not fully using the new closing code information to monitor timeliness of merit closures with customer contact. The cycle-time reports currently generated show only those merit closures that did not require customer contact but not the merit closures that required customer contact. The reports for monitoring cases requiring contact with customers are available on the system, but they have to be requested from the Headquarters Office.

- The lack of a process to report business results for technical screening applications that require contact with customers.

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The EP function does not include merit closures requiring customer contact in its business results. Currently, the business results reported in the EP Work Plan for technical screening applications include only the merit closures that did not require customer contact. In FY 2004, the EP technical screening centers processed 25,592 applications without contacting customers and 13,778 applications that required contacting customers.

We determined merit closures requiring customer contact took longer than those without customer contact. EP function reports showed the national average cycle times for merit closures with customer contact were 136 days and 166 days for FYs 2003 and 2004, respectively. In contrast, the cycle times for merit closures without customer contact were 106 days and 152 days for the same periods.

- A lack of customer feedback for technical screening applications that require customer contact.

The existing customer satisfaction survey sample is derived from IRS records sent to an independent contractor. However, a Modernization and Information Technology Services (MITS) organization Lead Information Technical Specialist advised us the records sent by the IRS, which are used to send out the customer satisfaction surveys, do not include a sample of merit closures that required contact with the customer. Customer contact may lengthen the processing time of the application and be seen as an increased burden by some of the customers. As a result, the feedback from customers on these types of applications may differ from that of the customers with whom no contact was required to resolve the applications. A representative sample of both types of customers is needed to provide EP function management with more complete feedback from customers.

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Improvements are needed in the procedures for contacting plans sponsors and the process for monitoring aged cases

Technical screeners can fax or call for additional information to resolve issues on the application. However, the EP function did not have a standardized set of written guidelines that are used by all of the technical screening centers on how often to contact the applicants. Instead, the EP function relied upon group managers to determine how many contacts the revenue agents should make and how to resolve the applications when there was no response. As a result, customers may have received different levels of service depending on which technical screening center was assigned the application.

For example, one screening center would send a fax to the plan sponsor asking for additional information and then make a telephone call if no response was received. If the information still could not be obtained after the fax and one telephone call, the application would be assigned to an unassigned inventory account. The application would remain in this account for a period not to exceed 25 calendar days before being reassigned to a field Determinations program group that would process it as a nonmerit determination application.

It was another technical screening center's policy to follow up with a second fax if no response was received to the first contact. If no response was received after the second fax, the group manager assigned the application to the technical screener to keep working as a nonmerit determination application, instead of assigning it to the unassigned inventory account.

A group manager at a third technical screening center had no set policy and allowed the specialists assigned to technically screen applications to determine how many times to contact plan sponsors.

EP function management recognized that inconsistencies existed among technical screening centers and decided to initiate a screening roundtable group in April 2004 to improve consistency. One of the group's initiatives was to revise an area handbook that was used by specialists

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working determination applications at the various technical screening centers. The handbook will include a written set of guidelines on how often to contact plan applicants and is designed to help EP function management identify and eliminate inconsistencies in the different technical screening centers' processes.

In addition to identifying insufficient procedures for contacting plan sponsors, we determined the process for monitoring aged applications could be improved. EP function managers were using a weekly inventory listing to identify and follow up on determination applications that had been assigned to a technical screener for more than 60 calendar days. However, with the goal for technical screeners set at 30 calendar days, the 60-day over-age indicator may be too high a threshold for managerial follow-up. An over-age indicator that is more consistent with the 30-day goal may help EP function management better monitor over-age applications, especially as inventory levels drop back down to normal in the future.

Recommendations

1. The Director, EP, should establish a process that will set a more realistic, achievable timeliness goal for merit closures based on anticipated receipts for the year.

Management's Response: The FY 2005 timeliness goal was modified in the Business Performance Review report to more realistically reflect current experience. In addition, EP function management will revisit the goal setting process as part of the development of the FY 2006 Work Plan.

2. To effectively track merit closures, the Director, EP Rulings and Agreements, should develop monitoring systems with the ability to:
 - Monitor the average cycle time for individual technical screening centers.
 - Include the timeliness results of applications requiring customer contact in the EP function performance measure for technical screening.
 - Monitor the average cycle time for applications requiring customer contact.

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- Include a representative sample of merit closures requiring customer contact in the customer survey to obtain feedback from all customers whose applications were processed using technical screening processes.
- Monitor over-age applications using an indicator that is more consistent with the Tax Exempt Quality Measurement System and customer service guidelines.

Management's Response: The TE/GE Division will complete the baseline requirements for the Tax Exempt Determination System (TEDS) Release 2 Business Objects implementation which will include reporting of average cycle time per screening center.

The TE/GE Division believes that including the results of applications that require customer contact in the performance measure for technical screening of applications that do not require customer contact will dilute the accuracy of the measure. Instead, the TE/GE Division will complete the baseline requirements for TEDS Release 2 Business Objects implementation which will include the reporting of cycle time for applications requiring customer contact.

A Request for Information Services has been submitted to the MITS organization to sample merit closures requiring customer contact as part of the customer survey process. Although TE/GE Division management does not believe the 30 day Tax Exempt Quality Measurement System benchmark would be helpful for monitoring screening timeliness because it was designed to measure the “perfect” merit closure without customer contact, they will revisit the time frame when the staggered remedial amendment process becomes effective for individually designed plans.

Office of Audit Comment: We agree with management's alternative corrective action since the TEDS Release 2 Business Objects implementation will include the reporting of cycle time for applications requiring customer contact.

3. The Director, EP Rulings and Agreements, should ensure the screening handbook being revised includes procedures for contacting plan sponsors when additional information is needed and for resolving applications

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when no response is received, to enable the EP function to provide a consistent level of service to customers.

Management's Response: The screening handbook is currently being revised to enhance consistency among screening centers. The handbook will mandate two contacts with applicants within a specified time frame. In the absence of unusual circumstances, cases for which no response is received will be converted to a determination review and sent to unassigned inventory.

Quality Assurance Reviews Have Surfaced Ongoing Problems With the Accuracy of Determination Letters

For the past 3 fiscal years (FYs 2002 – 2004), the EP Quality Assurance function has reported error rates of 17 percent, 22 percent, and 15 percent, respectively, for determination letters issued by technical screening centers. The errors reported by the EP Quality Assurance function include:

- Incorrect or missing dates for proposed or executed amendments.⁶ These dates are important because they help identify the amendments to which the determination letter applies.
- Incorrect law ruling caveats,⁷ omissions of caveats, and incorrect caveats. These could give plan sponsors a false sense of assurance if the wrong caveat was included in the determination letter. Also, plans have an increased risk of operating out of compliance with the applicable statutes.

The determination letter is the final product of the determination application process. Since plan sponsors rely on these letters to demonstrate that plans qualify for tax-exempt status, it is important that the letters are accurate. In addition, many plans are required to pay a fee to have the EP function evaluate the application and issue a determination letter, which emphasizes the need for accurate determination letters. Further, the determination letter

⁶ Amendments are changes that must be made to plans to maintain their qualified status.

⁷ A caveat is a confirmation and explanation of the scope of a favorable determination letter, indicating that the determination letter is applicable only for items in the plan that were reviewed by the technical screener. It also describes items and issues that may put at risk the plan's favorable status.

Opportunities Exist for the Employee Plans Function to Improve the Timeliness and Accuracy of Merit Closure Determination Letters

provides a historical record that can be useful to the EP function for processing future determination requests or when conducting plan examinations.

EP function Quality Assurance reports have consistently shown over the past 3 fiscal years that EP function management does not have reasonable assurance the technical screening centers are preparing accurate and correct determination letters. For example, Quality Assurance function recurring issue reports have consistently highlighted specific technical issues where frequent mistakes were made, including incorrect or missing amendment dates, incorrect law ruling caveats, omissions of caveats, and incorrect caveats. Although errors in determination letters identified by the Quality Assurance function are corrected either by the Quality Assurance function or the technical screening centers before they are issued, there may have been other favorable determination letters with similar errors that were not identified because the letters were not quality reviewed.

Because the quality of determination letters has been a continuing problem, EP function management initiated a peer review process in FY 2003 that was designed to improve quality. The peer review process is based on the principle that systematic monitoring is the most effective way to attain high-quality determination letters, since it is impractical to have managers review all applications processed in the technical screening centers. Peer reviewers evaluate the quality of the determination letters and, as such, are the primary means to ensure determination letters are accurate. If the peer reviewers identify errors, the determination letters are returned to the technical specialists for correction. After the letters have been peer reviewed, the managers may also select the application for review, but relatively few are reviewed by managers. Clerks then issue the determination letters unless an application is randomly selected by the system for quality review. While the peer review process may have helped reduce the error rate for determination letters in FY 2004, it has not been effective in reducing the error rate to an acceptable level.

In most technical screening centers, EP function specialists perform peer reviews of merit closure determination letters

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prepared by other specialists at their own center. At other technical screening centers, managers review the determination letters themselves instead of using the peer review process. Peer reviewing is a collateral duty in addition to working the individual inventory of applications. While this arrangement may be due to limited resources, one inherent shortcoming is that when technical screeners are peer reviewing determination letters for other employees, they are unable to continue working the determination applications assigned to them. This practice may have contributed to the length of time to work applications.

We identified several inconsistencies and potential weaknesses in the peer review process. For example, each Determinations program group manager decides how the reviews will be conducted. As a result, group managers had different standards for selecting applications to be included in the peer review process as well as different standards for selecting employees to perform the reviews. Specifically, some managers peer reviewed 100 percent of the technically screened applications and others reviewed only samples. In addition some managers assigned only senior-level employees to perform the reviews, while others assigned less-experienced employees.

Another potential weakness involved not always tracking or analyzing peer review results for individual groups. Such analysis could assist in identifying issues that exist in one group but not another and in determining if error trends are improving over time. For example, two of the technical screening centers were using screening review reports to identify types of errors, the number of cases with errors, and error rates. At two other technical screening centers, peer reviewers or the group managers returned cases to the employees for correction, but the types of errors and error rates were not being tracked. As a result, group managers from the latter two groups could not evaluate whether determination letter quality was improving. Consolidating and analyzing the results of peer reviews is an opportunity for EP function management to identify common mistakes and to address them through additional training or clarification of procedures.

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Recommendation

4. The Director, EP Rulings and Agreements, should revise processes designed to improve the quality of determination letters by:
 - Establishing more consistency in the administration of peer reviews.
 - Ensuring peer review results for individual groups are tracked and analyzed to identify error trends.
 - Addressing any error trends through clarifying procedures or providing education to technical screening analysts.

Management's Response: The Manager, EP Determinations, mandated that all groups perform a 100 percent peer review of merit closure cases to ensure the accuracy of the favorable determination letters, and that group managers gather and share results with specialists. The Determinations Quality Assurance Staff (QAS) office will review monthly group statistics and compare the results to Tax Exempt Quality Measurement System trends (which are shared organization-wide). The QAS office will cascade any exceptional findings of this study to all Determinations employees to promote consistency among groups.

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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of the audit was to determine whether the Employee Plans (EP) function determination process for merit closures ensures determination letter applications are timely and consistently processed in accordance with procedures and provides quality service to customers. We did not perform any independent testing to verify the accuracy of the data obtained from the Tax Exempt and Government Entities (TE/GE) Division management information system reports.

To accomplish our objective, we:

- I. Determined whether TE/GE Division management had established the necessary processes to ensure EP function Determinations program merit closures are timely processed.
 - A. Reviewed EP Work Plans and the Tax Exempt Quality Measurement System (TEQMS) standards to determine whether TE/GE Division management had established measurable EP function determination letter program goals for measuring the timeliness of merit closures.
 - B. Discussed monitoring systems with TE/GE Division management to identify methods used for tracking the timeliness of technical screening applications closed on merit. We determined whether there were any causes or factors that were inhibiting management from monitoring the length of processing time.
 - C. Determined how managers identified and monitored applications that had been assigned to technical screeners.
 - D. Analyzed EP Work Plans and Electronic Determination System reports to determine whether the merit closure program is producing the desired results of closing applications within 75 calendar days. We determined whether timeliness was contingent upon whether the application was closed with contacting the customer or without contacting the customer.
 - E. Determined whether the goal of closing all merit closure applications (including applications requiring customer contact) within 75 calendar days was an achievable, realistic goal.
- II. Determined whether the EP function determination process for merit closures ensures applications are consistently processed in accordance with procedures and provides consistent quality service to customers.

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- A. Analyzed the TEQMS summary reports for Fiscal Years 2002 through 2004 to determine whether the EP function determination letter program is producing the desired results for the quality of merit closures.
- B. Interviewed EP function Determinations program group managers to determine whether there were sufficient procedures for contacting plan sponsors.
- C. Conducted walk-throughs of merit closure screening activities at three of the technical screening centers located in Cincinnati, Ohio; Baltimore, Maryland; and El Monte, California; conducted telephone interviews with EP function Determinations program group managers in the remaining technical screening centers located in Brooklyn, New York; Chicago, Illinois; and Atlanta, Georgia; and obtained applicable documentation to determine whether EP function management had established standard processes for reviewing determination applications at the technical screening centers. We reviewed EP function Quality Assurance reports to determine whether the standard processes were adequate for assessing the qualified status of determination applications.
- D. Determined whether EP function management ensured peer reviews were consistently administered and peer review results for individual groups were tracked and analyzed to improve error trends.

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Timeliness and Accuracy of Merit Closure Determination Letters**

Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy A. Nakamura, Director

James V. Westcott, Audit Manager

Marjorie A. Stephenson, Lead Auditor

Michael A. McGovern, Auditor

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Timeliness and Accuracy of Merit Closure Determination Letters**

Appendix III

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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
JUL 27 2005

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MEMORANDUM FOR PAMELA J. GARDINER, DEPUTY INSPECTOR GENERAL
FOR AUDIT

FROM: Steven T. Miller, Commissioner *Sarah Halloran*
Tax Exempt and Government Entities Division

SUBJECT: Management Response to Draft Audit Report –
Opportunities Exist for the Employee Plans (EP) Function to
Improve the Timeliness and Accuracy of Merit Closure
Determination Letters (Audit # 200410013)

I have reviewed your report outlining opportunities for improvement in the processing of merit closure determination letters. I appreciate your thorough look at our program and your ideas for enhancing it.

As you mentioned in your report, the long-standing system for submitting and reviewing pension plans resulted in significant "peaks and valleys" in the number of determination applications received. In the past, the periods when we received large numbers of applications greatly taxed our resources and hampered our ability to timely process determination letters. Your report, however, scarcely acknowledges an important accomplishment -- EP management has made a substantial effort and devoted significant resources to design and implement a permanent solution to this problem.

In August, 2001, EP Rulings & Agreements (R&A) published a "White Paper" that proposed a wide range of process re-design possibilities to remedy this historical fluctuation in receipts, and we requested comments from the public on the various possibilities. After extensive consideration of the comments we received, and numerous interactions with practitioner and other stakeholder groups, we published a second "White Paper" in 2003 in which we reduced the number and refined the descriptions of possible process options. Our evaluation of input from a second public comment period resulted in the selection of a staggered remedial amendment period approach, as outlined in Announcement 2004-32. The implementation of this staggered approach will result in spreading the receipt of applications over a five year period for individually designed plans and over a six year period for pre-approved plans. Over time, this new approach should minimize the yearly fluctuations in numbers of applications submitted, and help EP R&A achieve consistent timeliness goals.

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In the following paragraphs, we will address the specific recommendations outlined in Audit Report # 200410013. If you have any questions about our response, please have your staff contact Rick Westley at (202) 283-9513 or Bob Bell at (513) 263-3567.

RECOMMENDATION 1:

The Director, EP, should establish a process that will set a more realistic, achievable timeliness goal for merit closures based on anticipated receipts for the year.

CORRECTIVE ACTIONS:

The implementation of the staggered remedial amendment period will minimize inventory backlogs and allow for improved planning and goal setting.

- (a) Actions were taken to modify the FY 2005 timeliness goal in the Business Performance Review (BPR) report to more realistically reflect current experience.
- (b) EP will re-visit the goal setting process as part of the development of the FY 2006 Workplan.

PROPOSED CORRECTIVE ACTION COMPLETION DATE:

- (a) Completed.
- (b) October 15, 2005.

RESPONSIBLE OFFICIAL:

Director, EP Rulings & Agreements.

CORRECTIVE ACTION MONITORING PLAN:

We will continue to monitor this process through the Business Performance Review.

RECOMMENDATION 2:

To effectively track merit closures, the Director, EP Rulings & Agreements, should develop monitoring systems with the ability to:

- Monitor the average cycle time for individual technical screening centers.
- Include the timeliness results of applications requiring customer contact in the EP function performance measure for technical screening.
- Monitor the average cycle time for applications requiring customer contact.
- Include a representative sample of merit closures requiring customer contact in the customer survey to obtain feedback from all customers whose applications were processed using technical screening processes.

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- Monitor over-age applications using an indicator that is more consistent with the Tax Exempt Quality Measurement System and customer service guidelines.

CORRECTIVE ACTIONS:

(a). EP management has been monitoring inventory in the screening centers via a weekly report prepared by the Determinations Program Analyst. This report provides valuable information regarding cases in various stages of the screening process and identifies potential backlogs in each of the individual screening centers. In this manner, we are looking at problems that may negatively impact cycle time measures and thus are going one step further than merely monitoring the numbers.

In response to part (a) of this recommendation, we discussed with the EDS programmer the feasibility of modifying EDS to allow us to monitor the average cycle time per screening center. We were advised that programming changes to EDS to permit this were unlikely to be approved or undertaken at present because EDS is scheduled to be replaced by TEDS within a relatively short time, approximately 18 months. The goal of part (a) of this recommendation can be achieved, however, by incorporating this report need into the requirements for the Business Objects implementation in TEDS Release 2. Accordingly, in response to part (a) of this recommendation, TE/GE will complete the baseline requirements for TEDS Release 2 Business Objects implementation to include reporting of average cycle time per screening center.

(b) When closing code 09 (customer contact) was first established, a decision was made to exclude these applications as "merit closures" for cycle time purposes. While they have not been included in the merit closure cycle time computation, the R&A Program Analyst monitors and measures "09" closures on a monthly basis to gauge processing effectiveness. "09" closures are included in the "all cases" cycle time computation. Combining these results with cycle time figures for the "06" closures would dilute the accuracy of the measure.

However, our response to part (b) of this recommendation is similar to our response to part (a). Since 09 closures are not specifically included in any cycle time computation, we discussed with the EDS programmer the feasibility of modifying EDS to allow us to obtain 09 cycle time reports. We were advised that such a change was unlikely to be approved or undertaken at present because of the impending replacement of EDS with TEDS. The goal of this recommendation can be achieved, however, by incorporating this report need into the requirements for the Business Object implementation in TEDS Release 2. Accordingly, in response to part (b) of this recommendation, TE/GE will complete the baseline requirements for TEDS Release 2 Business Objects implementation to include reporting of cycle time for closing code 09.

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(c) We agree with your recommendation that customer contact or "09" closures should be sampled as part of the customer survey process. RIS # EMP50022P00 has been submitted and is currently pending with MITS.

Your report mentions a 30-day timeframe under TEQMS. This 30-day period is designed to measure the "perfect" merit closure without contact. Since a substantial number of screening cases actually require contact and thus do not meet this criterion, it seems inappropriate to utilize this measure to gauge screening effectiveness. We do not believe the suggested 30-day timeframe would be helpful and would, in fact, flag such a high percentage of cases in the screening process that it would prove counterproductive. We agree that once the staggered remedial amendment process becomes effective for individually designed plans, we should re-visit the timeframe for monitoring screening timeliness. The current 60-day benchmark is, in our opinion, appropriate for a period of high receipts such as we experienced under GUST.

PROPOSED CORRECTIVE ACTION COMPLETION DATES:

- (a) & (b) December 15, 2005.
- (c) Completed.

RESPONSIBLE OFFICIAL:

Manager, EP Determinations.

CORRECTIVE ACTION MONITORING PLAN:

We will monitor the completion of corrective actions 2(a) and 2(b) at the monthly Director, EP and EO reviews of TEDS.

RECOMMENDATION 3:

The Director, EP Rulings & Agreements, should ensure the screening handbook being revised includes procedures for contacting plan sponsors when additional information is needed and for resolving applications when no response is received, to enable the EP function to provide a consistent level of service to customers.

CORRECTIVE ACTION:

The screening handbook is currently being revised to enhance consistency among screening centers. The handbook will mandate two contacts with applicants within a specified timeframe. The contact methodology will be left to the discretion of the employee and manager based on the circumstances of a particular case. In the

Opportunities Exist for the Employee Plans Function to Improve the Timeliness and Accuracy of Merit Closure Determination Letters

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absence of unusual circumstances, cases for which no response is received will be converted to a determination review and sent to unassigned inventory.

PROPOSED CORRECTIVE ACTION COMPLETION DATE:

November 15, 2005.

RESPONSIBLE OFFICIAL:

Manager, EP Determinations.

CORRECTIVE ACTION MONITORING PLAN:

The Manager, EP Determinations will receive regular project status updates from the manager of the technical screening function.

RECOMMENDATION 4:

The Director, EP Rulings & Agreements, should revise processes designed to improve the quality of determination letters by:

- Establishing more consistency in the administration of peer reviews.
- Ensuring peer review results for individual groups are tracked and analyzed to identify error trends.
- Addressing any error trends through clarifying procedures or providing education to technical screening analysts.

CORRECTIVE ACTION:

In April, 2005, the Manager, EP Determinations mandated that all groups perform a 100% peer review of merit closure cases to ensure the accuracy of the favorable determination letters. He also mandated that group managers gather and share results with specialists. The Determinations Quality Assurance Staff (QAS) will review the monthly group statistics and compare the results to TEQMS trends (which are shared organization-wide). QAS will cascade any exceptional findings of this study to all Determinations employees to promote consistency among the groups.

The differences in peer review methodology per group are justified based on staffing and location considerations. Managers are best positioned to determine which employees would be most effective in a peer review role.

PROPOSED CORRECTIVE ACTION COMPLETION DATE:

October 15, 2005 for the QAS review process.

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RESPONSIBLE OFFICIAL:

Manager, EP Determinations.

CORRECTIVE ACTION MONITORING PLAN:

The Manager, EP Determinations and the Managers, Determinations Areas 1 & 2, will monitor process via monthly first-line manager briefings.