

**ADVISORY COMMITTEE  
ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)  
PUBLIC MEETING**

**1111 Constitution Ave., NW  
Washington, DC  
June 21, 2002**

**Advisory Committee on Tax Exempt and Government Entities (ACT)  
Public Meeting  
Internal Revenue Service, 1111 Constitution Ave., NW  
Room 4718  
Washington, DC 20224**

**June 21, 2002**

**AGENDA**

- |               |   |
|---------------|---|
| 8:30 – 9:00   | Meet and Greet  |
| 9:00 – 9:30   | Welcome and Opening Remarks <ul style="list-style-type: none"><li>• Bob Wenzel, Deputy Commissioner of Internal Revenue</li><li>• David R. Williams, Chief Communications &amp; Liaison</li><li>• Evelyn Petschek, Division Commissioner, Tax Exempt and Government Entities Division</li><li>• Steven J. Pyrek, Designated Federal Official of the ACT</li></ul> |
| 9:30 – 10:00  | ACT Overview Report <ul style="list-style-type: none"><li>• Donald J. Segal, Chairman of the Advisory Committee on Tax Exempt and Government Entities</li></ul>   |
| 10:00 – 10:15 | Break   |
| 10:15 – 11:00 | <i>Life Cycle of a Public Charity</i><br>Victoria Bjorklund, Project Leader   |
| 11:00 – 11:45 | <i>TE/GE Education and Outreach</i><br>Mary Beth Braitman, Project Leader   |
| 11:45 – 12:45 | Lunch   |
| 12:45 – 1:30  | <i>Indian Tribal Consultation Process</i><br>David Mullon, Project Leader   |
| 1:30 – 2:15   | <i>Voluntary Correction Programs</i><br>Perry Israel, Project Leader  |
| 2:15 – 2:30   | Break   |
| 2:30 – 3:15   | <i>Employee Plans Small Business Access and Compliance</i><br>Brian L. Anderson, Project Leader   |
| 3:15 – 4:00   | Closeout  |

## ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES

### Member Biographies

#### EMPLOYEE PLANS

- **Brian L. Anderson**, Madison, WI

Mr. Anderson, an attorney and CPA, is a shareholder of the Madison law firm DeWitt Ross & Stevens S.C. He currently is the Chair of the IRS Great Lakes Area TE/GE Council, Chair of the Employee Benefits Committee of the Business Law Section of the State Bar of Wisconsin, and a member of the Federal Taxation committee of the Wisconsin Institute of Certified Public Accountants. Mr. Anderson is primarily involved with small and mid-sized employer groups.

- **Mary Beth Braitman**, Indianapolis, IN

Ms. Braitman is a partner in the law firm of Ice Miller, where her clients include various governmental retirement systems in Indiana, Iowa, Kansas, Kentucky, Massachusetts, Montana, Ohio, Oklahoma, Texas and Washington. She has worked extensively in pension and employment tax issues of state and local governments, Social Security coverage issues, and tax sheltered annuity programs in the kindergarten–grade 12 and university sectors.

- **Jonathan Barry Forman**, Norman, OK

Prof. Forman, Professor of Law at the University of Oklahoma, teaches courses on income taxation of corporations and individuals, pension and employee benefit plans, tax policy, procedures and welfare law. He has written extensively on tax and pension policy. He was a delegate to the National Summit on Retirement Savings, was a trial attorney with the Department of Justice and is a trustee of the American Tax Policy Institute.

- **Craig Hoffman**, Jacksonville, FL

Mr. Hoffman is the current President of the American Society of Pension Actuaries, where he has also served as a member of the Board of Directors and Vice President, as well as the Co-Chair of the Government Affairs Committee. Mr. Hoffman, who serves on

the editorial boards of several pension journals, is Vice President and General Counsel of SunGard Corbel, and was an expert speaker at the National Summit on Retirement Savings.

- **John W. Schroeder**, Santa Clara, CA

Senior Tax Benefits Counsel for Intel Corporation, Mr. Schroeder was a founding director of the Silicon Valley Benefits and Compensation Association. He has been active in the past in the Western Pension and Benefits Conference and the American Corporate Counsel Association. He has a large plan sponsor perspective as well as prior experience as counsel to a third party administrator of small plans.

- **Donald J. Segal**, New York, NY

Mr. Segal, a Fellow of the Society of Actuaries, is Senior Vice President and Research Actuary with The Segal Company. He currently serves as the Chair of the American Academy of Actuaries Pension Committee. He is the former Chair of the Pension Section Council of the Society of Actuaries and served on the Board of Governors of the Society of Actuaries.

## **EXEMPT ORGANIZATIONS**

- **Victoria B. Bjorklund**, New York, NY

Ms. Bjorklund is a partner in the law firm of Simpson, Thacher and Bartlett in New York, where her clients include educational organizations, tax-exempt health care organizations and private foundations involved in substantial domestic and international grant-making activities. She is a long-time active participant in the American Bar Association and is Chair of the ABA Section on Taxation – Exempt Organizations Committee.

- **Deirdre Dessingue**, Washington, DC

Ms. Dessingue is the Associate General Counsel of the United States Conference of Catholic Bishops in Washington, DC, and Co-Chair of the Religious Organizations Subcommittee of the American Bar Association Section on Taxation - Exempt Organizations Committee. She has particular expertise in the areas of prohibitions on political campaign activity, fund-raising limitations and religious organizations.

- **Karl E. Emerson**, Harrisburg, PA

Mr. Emerson is the Director of the Pennsylvania Bureau of Charitable Organizations, the state office charged with enforcement of the law that regulates organizations soliciting charitable contributions in Pennsylvania. He is a Past President and Vice President of the National Association of State Charity Officials (NASCO) and was a member of the NASCO Board for four years.

- **Sara E. Meléndez**, Washington, DC

Dr. Meléndez is the President and CEO of Independent Sector, a nonprofit, nonpartisan coalition of more than 700 national nonprofit organizations, foundations and corporate philanthropy programs, collectively representing tens of thousands of charitable groups in every state. Through research and public policy work, Independent Sector works to accomplish its mission of strengthening the nonprofit and philanthropic community to foster private initiative for the public good.

- **Elizabeth D. Nunnally**, Minneapolis, MN

Ms. Nunnally is Chief Financial Officer of the Academic Health Center at the University of Minnesota and formerly the Director of Taxation and Debt Management at the University. She is a CPA and a member of the Taxation Council of the National Association of College and University Business Officers (NACUBO).

- **John Von Kannon**, Washington, DC

Mr. Von Kannon is the Vice President and Treasurer of The Heritage Foundation, a public policy organization based in Washington, DC. In this position, he has responsibility for matters relating to the finances and taxation of that organization. As head of the foundation's Development Department, Mr. Von Kannon oversees its education and marketing programs to donors.

## **GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS**

- **Daryl Dunagan**, Frankfort, KY

Mr. Dunagan is the Program Manager of the Division of Social Security for the Kentucky Controller's Office. He has more than 25 years experience with Social Security coverage, employment taxes

and information return reporting for state and local governments and is a past President of the National Conference of State Social Security Administrators. He currently chairs its Government Affairs Committee.

- **Don F. Waugh**, Raleigh, NC

Mr. Waugh is the Assistant State Controller of North Carolina. He has held various positions in state government since 1975 and has been actively involved in the formation and operations of the Controller's Office. He is a member of the Government Finance Officers Association and the National Association of State Auditors, Controllers and Treasurers.

## **GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS**

- **Jayne Fawcett**, Uncasville, CT

Ms. Fawcett currently serves as Treasurer and Board Member of the United South and Eastern Tribes, Inc. (USET). She has over 20 years of tribal government experience including elected service as the Vice Chair of the Mohegan Tribe of Connecticut. She currently holds the position of Tribal Ambassador for the Mohegan Tribe.

- **David Mullon**, Tahlequah, OK

Mr. Mullon is currently Associate General Counsel of the Cherokee Nation. He has extensive experience in tribal government tax and administration issues, particularly those unique to Oklahoma. Mr. Mullon previously served as Attorney General of the Muscogee (Creek) Nation and was in private practice for several years in Tulsa, OK.

## **GOVERNMENT ENTITIES: TAX EXEMPT BONDS**

- **Terence P. Burke**, Dallas, TX

Mr. Burke is a Partner with the public accounting firm of Ernst & Young LLP. Mr. Burke specializes in post-issuance arbitrage compliance for tax-exempt bonds. He is a Certified Public Accountant and serves as advisor to the Government Finance Officers Association Debt and Fiscal Policy Committee.

- **Perry E. Israel**, Sacramento, CA

Mr. Israel is a partner in the Tax and Public Finance Department of Orrick, Herrington & Sutcliffe, L.L.P. He specializes in tax-exempt financing, tax-exempt organizations, low-income housing tax credits and mortgage credit certificates. Israel is an active member of both the Committee on Tax-exempt Financing of the American Bar Association Section on Taxation and the National Association of Bond Lawyers. He served as a board member of NABL from 1993 to 1995 and Secretary from 1994 to 1995.

**GENERAL REPORT  
OF THE  
ADVISORY COMMITTEE  
ON TAX EXEMPT AND GOVERNMENT ENTITIES**

The Advisory Committee on Tax Exempt and Government Entities (ACT) was established to provide an organized public forum for discussion of issues related to the unique customer base served by the Tax Exempt and Government Entities Division of the IRS (TE/GE). TE/GE's customers include employee retirement plans; charities and other tax-exempt organizations; tax-exempt bond issuers; federal, state, local and Indian tribal government bodies, and the professionals who deal with these entities. Each of these groups has a special relationship with the IRS. They generally are not subject to tax but must comply with specialized and highly complex provisions of tax law.

We believe the recent reorganization of the IRS into four operating units aligned with customer characteristics will benefit all taxpayers and IRS customers – and none more so than the customers of TE/GE. Under the IRS's former organizational structure, geographically dispersed district offices of Employee Plans and Exempt Organizations administered applicable tax law under a decentralized system, which inhibited consistency and uniformity of approach. No offices existed under the old structure to specifically address the particular needs of the tax-exempt bond and government entities communities.

The new IRS organization created TE/GE as one of four operating divisions. It not only focuses attention on this important sector of the American economy but also provides an opportunity for the IRS to develop specialized outreach and education programs, products and services to enhance voluntary compliance through increased awareness. Several of the ACT's project teams focus on the new challenges and opportunities that arise for TE/GE by virtue of the new emphasis on outreach and education.

It has been almost one year since the ACT met in Washington for our orientation and first working session. The 18 members of the ACT cover the broad range of TE/GE customer groups. Six members represent the employee retirement plans community, six the exempt organizations community, and six the customers served by the government entities operation – tax exempt bonds; federal, state and local governments; and Indian tribal governments. The members include lawyers, accountants, state officials, officers of not-for-profit organizations and Indian tribal governments, university staff, an investment manager, and an actuary.

At our first working meeting last June, we organized ourselves into three subcommittees, corresponding to the three operating units of TE/GE. But in selecting the five projects to work on, we deliberately chose two that cut across TE/GE's operating units – increased education and outreach, and voluntary correction programs.



We believe that this combination of subject-matter specific topics and cross-cutting topics can help TE/GE focus its resources on several levels for the benefit of its customers.

Following are summaries of the five ACT projects being presented today to the Commissioner and senior leadership of TE/GE.

## **I. Life Cycle of a Public Charity**

### *Issue*

Given that many organizations that are exempt from federal income taxation under Internal Revenue Code section 501(c)(3) have limited administrative resources (referred to as “charitable organizations”), these charitable organizations are as likely as or more likely than others to use the Internet for their informational needs. Recent data collected from the IRS’s Customer Account Service Center in Cincinnati, Ohio, shows that individuals contact the IRS with questions about charitable organizations significantly more frequently than with questions about other exempt organizations and employee plans. We commend the IRS for the significant amount of information currently posted on its website, and in particular for posting information on that website geared towards charitable organizations. As postings geared toward charitable organizations increase in number, however, we believe that users would benefit from having these materials organized in a more coherent manner that would make sense to novice and expert alike.

### *Recommendation*

We therefore recommend the posting of two simple overview charts in a user-friendly graphic format, such as a “subway map” layout. Specifically, the Life Cycle project team has created two charts, respectively entitled “Life Cycle of a Public Charity” and “Life Cycle of a Private Foundation” and recommends that the IRS adopt the chart-with-links format and post the charts to the Charities portion of its website. In addition, we recommend that the IRS prepare and post appropriate materials that can be accessed, or linked, to each item on the chart. A demonstration of a simulated website offering of these two charts, together with the materials linked to each of the charts, will be presented at the public meeting on June 21, 2002.

## **II. TE/GE Education and Outreach**

### *Issue*

What kinds of education and outreach do TE/GE customers need and how can those needs be prioritized?

### *Recommendations*

First, we are convinced that the Web will be a critical component of any TE/GE educational efforts as the division moves towards providing materials in a self-service environment. We are making a number of specific recommendations with respect to control over Web pages for TE/GE divisions, as well as landing page design. Second,

we are making a number of recommendations with respect to additional education materials. A number of those involve creation of relatively brief “primer” pieces. Our recommendations in this area integrate in significant fashion to two other ACT projects: the Exempt Organizations Life Cycle project and the Employee Plans Small Business Access and Compliance project. Third, TE/GE can build on accomplishments to fine-tune a marketing strategy by considering both possible “primary” and “secondary” distribution methods. We believe there are primary distribution mechanisms (for example, the IRS web site, mailings, emails to customers) as well as a secondary “marketing” distribution network. Our report identifies certain associations, groups, and methods as likely candidates for a secondary distribution mechanism for IRS materials.

### **III. Tribal Consultation Policy**

#### *Issue*

Unlike several other federal agencies that have regular dealings with federally recognized Indian Tribes, the Internal Revenue Service has never adopted a Tribal consultation policy. We believe that the Service should develop a formal Tribal consultation policy through a collaborative process that engages the Indian Tribal governments that will be affected by the policy.

#### *Recommendation*

The Service should follow a four-step process in developing a formal Tribal consultation policy:

1. Giving notice to all federally recognized Indian Tribal and Alaska Native governments that the Service intends to adopt a Tribal consultation policy;
2. Conducting a series of regional consultation meetings with representatives of Tribal governments;
3. Circulating and receiving comments on a draft consultation policy; and
4. After reviewing and evaluating Tribal and other comments, adopting a formal Tribal consultation policy.

### **IV. Voluntary Correction Programs**

#### *Issue*

TE/GE should increase the opportunities for customers to voluntarily determine and correct their compliance problems.

#### *Recommendations*

Our overall recommendation is that TE/GE continue to develop appropriate mechanisms for self-correction, building upon the past successes in the Employee Plans area and using parameters set forth in the report relating to equity and fairness. We specifically set forth recommendations for different divisions of TE/GE.

#### Employee Plans:

- Extend the period for retroactive corrections.
- Establish a program for filing in gaps in data.
- Extend the current program to allow for correction of form deficiencies.

- Develop correctional methods for errors that do not violate particular code sections.
- Provide additional guidance on reporting income from corrections
- Allow corrections during the determination letter process.
- Encourage self-audit programs by providing for reduced sanctions or extended periods for correction.

#### Tax Exempt Bonds

- Work with industry participants to develop appropriate penalties for violations in the context of self correction.
- Encourage development of issuer-based self-audit programs by providing for reduced sanctions or extended periods for self-correction.
- Use the information obtained from audits and reported self-corrections to provide additional guidance to issuers as to particular problem areas.
- Require that Form 8038-T be filed even if no rebate is due.
- Provide compliance information to issuers at the time the Form 8038, 8038-G, or 8038-GC is filed.

#### Exempt Organizations

- Assist taxpayers in better understanding the life cycle of the exempt organization.
- Make the determinations process more efficient, including additional education about compliance.
- Develop a mechanism to deal more efficiently with changes in purpose of an exempt organization.
- Develop a standardized settlement agreement for compliance issues.
- Provide a self-correction program relating to growth of previously dormant organizations.
- Provide a self-correction program relating to changes in public support status.
- Consider extension of the VCP for the tax treatment of payments to foreign nationals.
- Provide private foundations with the ability to correct procedural mistakes under Section 4945.

#### Federal, State and Local Governments

- Clarify the FSLG interface with its customer base, including development of information portals.
- Explore the concept of various self-correction and compliance programs.
- Leverage participation in the Employment Tax Advisory Committee to further develop closing agreement opportunities.
- Develop a comprehensive marketing plan for FSLG.

### Indian Tribal Governments

- Consider concept of self-correction and compliance programs, using Tribal consultation policy to work with Tribes to determine areas of particular concern.

## **V. Employee Plans Small Business Access and Compliance**

### *Issue*

The TE/GE Division recognizes that maintenance of retirement plans is less common among small employers than among large employers. TE/GE is devoting significant Customer Education & Outreach (CE&O) resources toward increasing small-employer access to retirement plans, yet maintaining compliance with plan-qualification rules. For example, the Employee Plans Division of TE/GE is preparing a brochure to help employers choose an appropriate retirement plan. The TE/GE Division is also participating in the 2002 National Tax Forum Program.

### *Recommendations*

We commend TE/GE for focusing its EP CE&O activities on small employers. We believe that additional CE&O efforts should be made to promote the easiest plans (payroll-deduction IRAs, SEPs, and SIMPLE plans) and to provide guidance regarding plan administration.

Retirement-plan compliance problems generally arise from improper administration of plans. Anecdotal evidence suggests that some retirement-plan providers "sell" plans but do not help administer them. We recommend that the TE/GE Division devote more attention on improving the administration of plans by employers that want to comply but do not understand how to comply. In particular, the TE/GE Division should encourage plan-operation manuals, develop compliance checklists for use by employers, and improve the assessment of which plans need examination and education.

## **Conclusion**

The Advisory Committee would like to express our appreciation to the Commissioner of the Tax Exempt and Government Entities Division and all her staff. They have all been very generous with their time, making themselves available to the workgroups whenever we needed to meet with them, and speaking freely about the operations of their entities, their problems, and their objectives. The Committee could not have completed our projects as efficiently without their help.

**ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**I. LIFECYCLE OF A PUBLIC CHARITY  
PROJECT GROUP**

VICTORIA B. BJORKLUND, PROJECT LEADER  
DEIRDRE DESSINGUE  
KARL E. EMERSON  
JOHN VON KANNON

JUNE 21, 2002

## **INTRODUCTION**

More and more individuals and tax-exempt organizations are using the Internet daily as a source of information. According to a press release of the Computer Industry Almanac, Inc. the number of Internet users worldwide will increase from 533 million in 2001 to 945 million by 2004. At the same time, the number of organizations seeking recognition of exemption from federal income taxation under Internal Revenue Code section 501(c) has grown to over 87,000 per year from approximately 40,000 in 1990. There are estimated to be more than 1.3 million charitable organizations in the United States today. Many of these organizations have very limited access to legal counsel or professional tax advisors, yet they are eager to operate properly. Finally, budget restrictions on the IRS have limited its capacity to increase the number of IRS employees to keep pace with the growth of the tax-exempt sector. For all these reasons, the Internal Revenue Service TE/GE Division (the "IRS") has wisely focused on improving the content of, and the ease of using, its website.

## **DISCUSSION**

Given that many organizations that are exempt from federal income taxation under Internal Revenue Code section 501(c)(3) (which will be referred to generically as "charitable organizations" in this report) have limited administrative resources, these charitable organizations are as or more likely than others to use the Internet for their informational needs. In addition, recent data collected from the IRS' Customer Account Service Center in Cincinnati, Ohio, shows that individuals contact the IRS with questions about charitable organizations significantly more frequently than with questions about other exempt organizations and employee plans. The Life Cycle Subcommittee commends the IRS for the significant amount of information currently posted on its website, and in particular, for posting information on that website geared toward charitable organizations. The Life Cycle Subcommittee especially commends the IRS for adding the "Charities & Nonprofits" line to the home page's "Contents." This addition has made the website significantly easier for exempt organizations to navigate.

Further, the Life Cycle Subcommittee has noted that the TE/GE Division very successfully responded rapidly to requests for guidance following September 11, 2001, by posting documents on the IRS website. In addition, as the law changed with the enactment of federal disaster relief legislation, the IRS was able immediately to revise, and the public was able immediately to access, that guidance. "Disaster Relief: Providing Assistance Through Charitable Organizations" has been widely hailed in the field as a prototype. Through its online publication, the IRS was able quickly and cost-effectively to provide, and update, information of value to its charitable customer segment. "Disaster Relief" joins the well-received "Rebuttable Presumption Procedure is Key to Intermediate Sanctions Compliance" and "Publication 1771 – Charitable Solicitations" on the charities landing page.

The Life Cycle Subcommittee applauds these timely and helpful publications and their easy website availability. It also applauds the posting of IRS forms, including the previously unavailable Form 8734 (Support Schedule for Advance Ruling Period). As these postings increase in number, however, the Life Cycle Subcommittee believes that users would benefit from having these materials organized in a more coherent manner that would make sense to novice and expert alike.

## RECOMMENDATIONS

The Life Cycle Subcommittee therefore recommends the posting of at least two simple overview charts in a user-friendly graphic format, such as a “subway map” layout.

The Life Cycle Subcommittee has created two charts, respectively entitled “Life Cycle of a Public Charity” and “Life Cycle of a Private Foundation.”<sup>1</sup> The term “Life Cycle” was selected to communicate to users that each chart provides an overview of a charity’s “life” from incorporation to dissolution. By clicking on any heading on either Life Cycle chart, the user would immediately access narrative explanations and applicable forms and instructions. These texts and forms could be downloaded and printed. Ideally, the forms could be filled in and submitted or “e-filed” in the future when e-filing becomes a reality for exempt organizations.

In addition, working with IRS officials, the Life Cycle Subcommittee has selected possible materials that can be “linked” to each point on the charts. Copies of both charts and a landing page that would precede the charts are attached to this report. This has been a constructive exercise as it has shown where the IRS has appropriate explanatory text already in published form and where additional text is needed. As an example of the latter category, the Life Cycle Subcommittee created a draft text on “Charity Auctions” based on an existing regulation. It also created a draft Landing Page for the Life Cycle Charts for the IRS to consider in response to a concern that many users might not know the difference between a charity classified as a public charity and a charity classified as a private foundation.

The Life Cycle Subcommittee therefore recommends that the IRS adopt a “Life Cycle of a Public Charity” chart and a “Life Cycle of a Private Foundation” chart and post the charts to the Charities portion of its website. In addition, the Life Cycle Subcommittee recommends that the IRS also prepare and post appropriate materials that can be accessed, or linked, to each item on the charts. Some of these “linked” materials would be informational in nature and contain only narrative text. Other of these “linked” materials would consist of actual IRS forms of use to a charitable organization, such as IRS Form 1023 (Application for Recognition of Exemption), IRS

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<sup>1</sup> *The first chart shows the main points of intersection between the IRS and a charitable organization classified as a public charity described in Internal Revenue Code sections 509(a)(1), (a)(2), or (a)(3). The second chart shows the points of intersection between the IRS and a charitable organization classified as a private foundation within the meaning of Internal Revenue Code section 509(a).*

Form 990 (Return of Organization Exempt from Income Tax), and the relatively obscure Form 8734 (Support Schedule for Advance Ruling Period) and their accompanying instructions.

A demonstration of a simulated website offering of these two charts, together with the materials linked to each of the charts, will be presented at the public meeting on June 21, 2002. We also recommend that the IRS prepare additional material, as needed, to instruct the public on any point of intersection where there is not now sufficient explanatory text.

## **CONCLUSION**

Given the growing number of Internet users, and the increasing reliance by charitable organizations on the IRS' website as a source of information, it is more important than ever that the IRS' website continue to provide easily-accessible information to charitable organizations in a user-friendly format and at low cost. We commend the IRS and the TE/GE Division for its great strides in website postings over the past year and for adding "Charities and Nonprofits" to the Contents bar on the home page. We recommend the Life Cycle Charts as a way to organize more coherently the existing and future material for the benefit of charitable organizations.

Attachment 1: Landing Page for Life Cycle Charts

Attachment 2: "Life Cycle of a Public Charity" Chart

Attachment 3: "Life Cycle of a Private Foundation" Chart



## Landing Page for Life Cycle Charts – Charitable Organizations

Organizations that are formed for charitable, religious, educational, scientific, or literary purposes, or for the fostering of national or international amateur sports competition or the prevention of cruelty to children or animals, and which meet the requirements of Internal Revenue Code section 501(c)(3) are exempt from federal income tax as “charitable organizations”. In addition, contributions made to charitable organizations by individuals and corporations are deductible under Code section 170.

Every charitable organization exempt from federal income taxation is classified as either a “public charity” or a “private foundation.” Generally, organizations that are classified as public charities are those that (i) are churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges and universities, (ii) have an active program of fundraising and receive contributions from many sources, including the general public, governmental agencies, corporations, private foundations or other public charities, (iii) receive income from the conduct of activities in furtherance of the organization’s exempt purposes, or (iv) actively function in a supporting relationship to one or more existing public charities. Private foundations, in contrast, typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources) and most have as their primary activity the making of grants to other charitable organizations and to individuals, rather than the direct operation of charitable programs.

If you think your charitable organization is or will be a public charity, click [\*\*Life Cycle of a Public Charity\*\*](#) to view a chart showing the life cycle of a public charity. This chart contains links to helpful information about points of intersection between your organization and the IRS, including access to explanatory information and forms that your organization may need to file with the IRS.

If you think your charitable organization is or will be a private foundation, click [\*\*Life Cycle of a Private Foundation\*\*](#) to view a chart showing the life cycle of a private foundation. This chart contains links to helpful information about points of intersection between your organization and the IRS, including access to explanatory information and forms that your organization may need to file with the IRS.

Search

Forms and Publications Finder

Search Help

**contents**

- Business League Orgs
- Charitable Orgs
- Employee Assocs
- Fraternal Societies
- Labor & Ag Orgs
- Political orgs
- Social Clubs
- Social Welfare Orgs
- Veteran's Orgs
- Other Tax-Exempt Orgs

**resources**

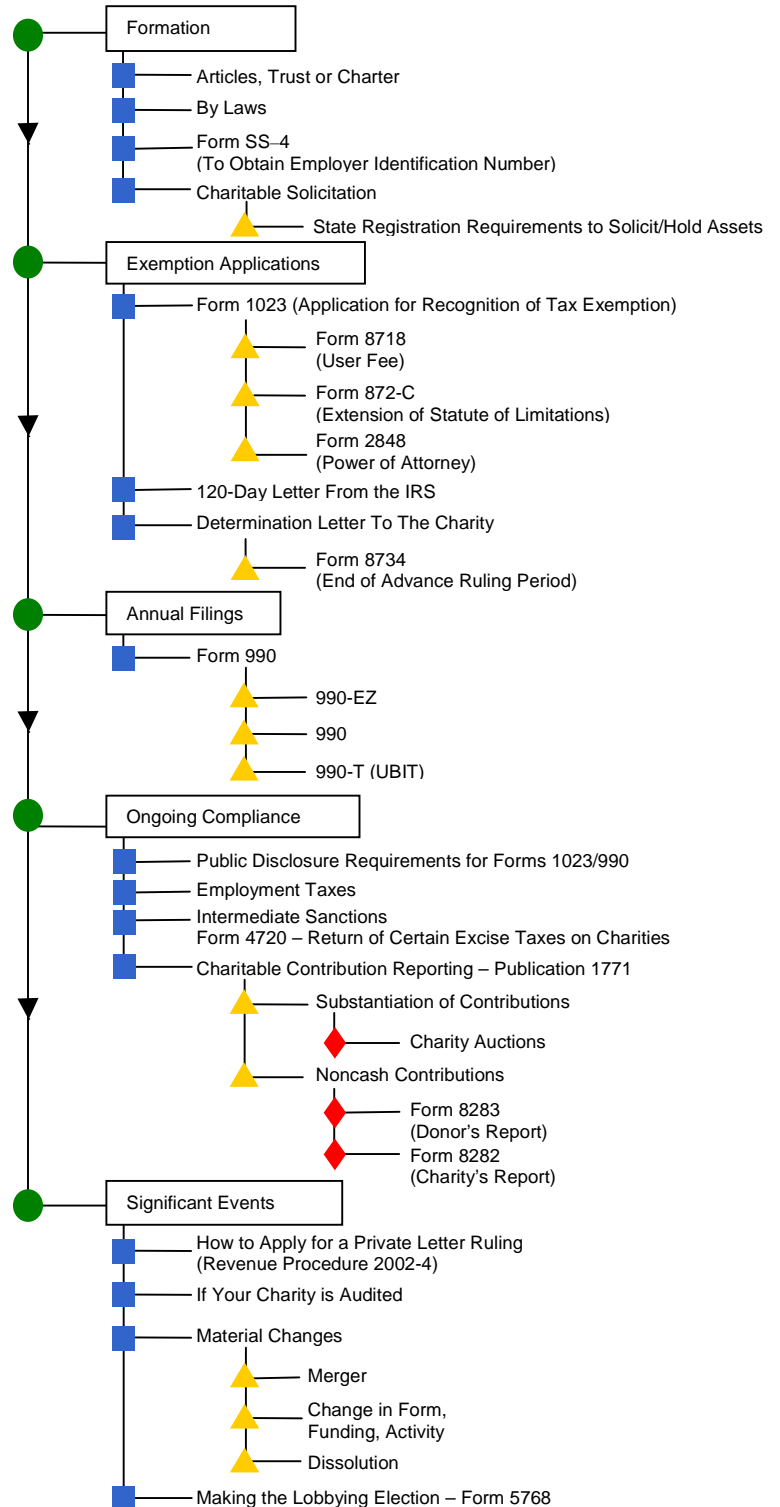
- e-file
- Forms and Publications
- Where to File
- Contact My Local Office
- FAQs
- Taxpayer Advocate

**topics**

- Types of Tax Exempt Orgs
- Field Memoranda
- EO Calendar of Events
- EO Application Process
- More Topics....

# Charities & Non-Profits

## Life Cycle of a Public Charity



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**resources**

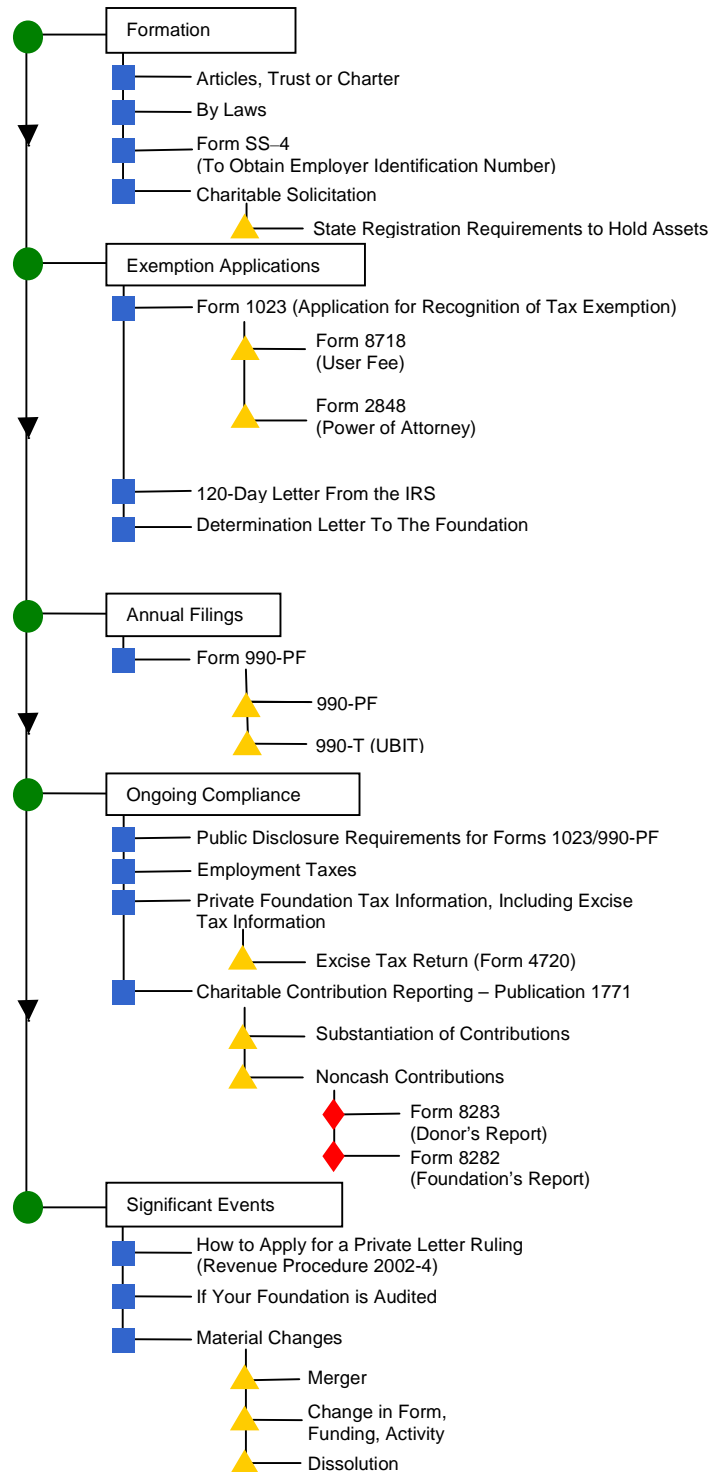
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# Charities & Non-Profits

## Life Cycle of a Private Foundation



**ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**II. TE/GE EDUCATION AND OUTREACH  
PROJECT GROUP**

MARY BETH BRAITMAN, PROJECT LEADER  
TERENCE P. BURKE  
DARYL DUNAGAN  
SARA E. MELÉNDEZ

JUNE 21, 2002

## I. INTRODUCTION

The goal of this Education and Outreach project is to make recommendations for education and outreach projects for the three components of TE/GE. Our group assessed customer needs, reviewed existing TE/GE products and methods of distributions, and recommends future projects.

As we worked on our project, four major areas of exploration developed. First was available customer information, the second was customer contacts at the call site, the third was additional materials that would be useful to TE/GE customers, and the fourth was dissemination of useful information to customers. As we explored these areas, certain premises emerged.

First, we are convinced that the WEB will be a critical component of any TE/GE educational efforts as the division moves towards providing materials in a self-service environment. As well, we realize forms and printed publications will still remain important as some TE/GE customers do not have access to electronic materials.

Second, the concept of "primer" materials generally emerged as a missing component. Many, although by all means not all, of our recommendations, involve creation of relatively brief "primer" pieces. This component integrates in significant fashion to two other ACT projects: the Exempt Organizations Lifecycle project and the Employee Plans Small Business Access and Compliance Project Group.

Third, TE/GE can build on accomplishments to fine-tune a marketing strategy by considering both possible "primary" and "secondary" distribution methods. We believe there are primary distribution mechanisms (e.g., the IRS web site, mailings, emails to customers; and a secondary "marketing" distribution network). As to this, our report identifies certain associations, groups, and methods as likely candidates for a secondary distribution mechanism for IRS materials.

## II. MISSION

- Identify existing educational, information and outreach inventory,
- Identify educational gaps/needs for TE/GE components and also for TE/GE customers,
- Solicit information on needs (among ACT members) and among TE/GE customers,
- Consider "primer" level materials v. more advanced publications,
- Consider how to disseminate information – most reliable means, most cost efficient means, and
- Develop "marketing strategy" for TE/GE educational materials and outreach.

### **III. USE OF THE WEBSITE**

#### **A. General**

We are convinced the TE/GE web site is a critical component of any TE/GE education and outreach effort. We believe the site can achieve better and more economical communications with significant portions of the TE/GE customer base. Consequently, we spent considerable time reviewing its structure, adaptability and possible expansions. One of our guiding principles was that our recommendations should enable TE/GE customers to self serve to the extent appropriate and desirable.

#### **B. Design**

We believe a massive improvement was made during the course of our working sessions – giving TE/GE its own “landing pages.” These pages include “Retirement Plans,” “Charitable and Non-Profits,” and “Governmental Entities.” The old structure was inappropriate for a majority of TE/GE customers and made usage quite difficult. (For example, previous access for the TE/GE customers was through "Tax Information for Business" link). The design that was launched in early February 2002 recognized the unique nature of TE/GE customers, and was a major step in the right direction. We commend the IRS for this major improvement. We understand the immediate result is increased usage of the site with respect to TE/GE customers. We think this critical design change can be further refined to better serve the stakeholders.

#### **C. Life Cycle Concept as “Roadmap”**

We reviewed this concept as a possible communication portal upon learning that another team was developing a “Life Cycle of a Public Charity” concept that could also serve as a portal or “map” into the EO web site materials. See the Life Cycle Report for a complete explanation of their design. After consideration, we warmly embrace the concept of a “Life Cycle” as a road map into the Web pages for several TE/GE business units. We started with the “Life Cycle of a Public Charity” developed by another ACT team and built a similar application for two other business units. We believe this could be a significant tool for the web site ease of use, as well as the framework for customer education. Table I is the Life Cycle of a Public Charity, Table II is the Life Cycle of a Retirement Plan, and Table IV is the Life Cycle of a Bond Issuance. After discussion, we concluded that this concept would not lend itself to the FSLG area or the ITG area. We suggest that the TE/GE staff continue to consider ways to structure the web site to utilize these road maps. **Note:** During the course of this project, EP has decided to unveil their campaign on Life Cycle of a Retirement Plan in July 2002 at the six 2002 Nationwide Tax Forums and the Tax Talk Today TV program.

#### **D. General Web Site Improvement**

We have several general recommendations with respect to the landing pages themselves for Exempt Organizations (EO), Employee Plans (EP), Federal, State and

Local Governments (FSLG), Indian Tribal Governments (ITG), and Tax Exempt Bonds (TEB). We believe that each page owner should have control over the "Contents", "Resources," and "Topics" shown on the left-hand side of each landing page, instead of being committed to any standard links that apply to the entire IRS. This flexibility is essential to the success of these pages, and we believe it is best achieved by page owner control. For example, it would be much more helpful to have "Resources" tailored to each division. It would be confusing and frustrating for a plan participant to be on the EP page, select contact local office and get the general taxpayer number, only to use it and be then told to call the TE/GE number. We have shown specific page suggestions on a very preliminary basis, and we are certain the page owners will have other recommendations as this concept continues to develop.

We do realize there are some overlapping issues (such as employment taxes, 1099 reporting, etc.) between the different pages' owners. We defer to the owners to decide whether repeating material on different pages or linking to each other's pages would be the most user-friendly.

### **(1) EO Improvements**

While some small nonprofit organizations do not yet have access to the internet and the IRS web page, the number that do is increasing significantly and it will become the most powerful tool for communicating with exempt organizations. The goal of effective web page communication should include the roadmap, The Life Cycle of a Public Charity. Contents should deal with nonprofits and foundations only. The Life Cycle Report has additional suggestions for the landing page.

### **(2) EP Improvements**

We realize that EP's FY 2002 Work Plan calls for a tailored education program focused on customer sub-segments. We have tried to particularly include that focus in our suggestions for the EP Topics (see below). We believe that to some degree EP customers do sort by plan type, which is why we suggest the Topic basis we show below.

We recommend there should be appropriate links to DOL and PBGC sites and materials. In addition, we urge the IRS to investigate links to other sites, for example, some of the associations listed in VI below. There should be clear ways available to show an exit and reentry from the IRS site. We think this could be very helpful to the users.

### **(3) FSLG Improvements**

We recommend TE/GE allocate the necessary resources to fully develop the FSLG web page. It appears to us that FSLG customers are a group that will benefit from a strong web presence. It is our experience that the majority of state

and local government entities have Internet access and readily utilize the Web as a research and informational tool. We suggest enhancing the FSLG web site will greatly assist FSLG as they identify their customer base, determine their informational needs and develop applicable educational materials. This is especially critical to an agency such as FSLG that is building their organization from the ground floor. A FSLG web page with a bounty of high-quality information will go a long way to introducing FSLG to its customers nationwide. It is also an efficient and easy way to provide these 90,000 customers with forms, guidance, hot topics and links in this day of dwindling resources at both the federal and state/local levels. Table III contains suggestions for the landing page.

We also recommend there be appropriate links to SSA for a discussion of Section 218 agreements for Social Security coverage of government units.

#### **(4) ITG Improvements**

As with FSLG, we particularly feel that ITG customers will be perhaps best reached via the WEB. Due to the geographic remoteness of some customers, the near universality of accession of this population, and the turn around times on distribution of written material, this customer base is a natural for the WEB. We think this page should have a strong sense of its own identity and be readily identifiable with high acceptance to its population. We recognize, however, that the diversity of ITG customers limits the use of the WEB to very general information (such as payroll taxes), since specific issues are unique to each tribe. We believe the WEB would be an excellent place to publish the "Process for Establishing a Tribal Consultation Policy" developed by the ACT in order to provide easy access of this information to the ITG customer base.

#### **(5) TEB Improvements**

Overall we are pleased with the organization and content of the Tax Exempt Bond (TEB) Division web pages. TEB has been effective at posting a significant amount of information that is available to their customer base. We believe TEB should consider the "Lifecycle of a Bond Issuance" (Table IV) concept as a page guide that quickly and easily links visitors to detailed information about the topics. Finally, the landing page for TEB has a link to page for "PLRs, TAMs and FSAs" that contains a listing of those items related to tax-exempt bonds. However, unlike similar listings under the "Tax Kit" page, the PLR page does not provide a brief description of the content of each PLR, TAM or FSA listed. The addition of brief summaries for each item would make the page even more user friendly.



## **E. Specific Internet Page Suggestions**

In this section we have developed our preliminary suggestions for specific page materials. We realize this is very much a work in process. We have worked with the page owners, but we also realize that as all the ACT recommendations are considered there will undoubtedly be modifications that will occur.

### **(1) Exempt Organizations ([www.irs.gov/eo](http://www.irs.gov/eo)):**

#### **(a) EO Contents**

- Life Cycle of a Public Charity (developing the individual contents)
- Types of Tax Exempt Organizations
- Donor Information
  - Information to Donors -- What is tax deductible?
  - Are you contributing to an organization where contributions are deductible?
  - What information must a public charity give you?
- Reporting
- Lobbying Expenditures Reports

#### **(b) EO Resources**

- EO Customer Account Services
- Publication 78, Search for Tax Exempt Organizations
- EO Forms and Publications
- EO FAQs
- EO Taxpayer Assistance (Call Site Information)
- List of Contact Numbers for State Secretary of State Offices and State Sales Tax Offices

#### **(c) EO Topics**

Some of these materials already exist. Some are in process, and others are in the planning stages. We recommend completing these materials as soon as possible. Topics targeted to exempt organizations should be clustered together, as should topics directed toward contributors. See also Table V.

- EO Application Process
- EO Calendar of Events
- EO in Depth

- EO Public Disclosure Requirements
- Exempt Organization Statistics
- Field Memoranda
- Filing Tips
- Publication 557, Tax Exempt Status for Your Organization
- Lobbying rules and reporting requirements for 501c3s
- Tax Topics
- Tax Treaty Information
- Unrelated Business Income Taxes
- Charitable Contributions: Substantiation and Disclosure
- Disaster Relief
- What is Tax Deductible?
- 527 Organizations

**(2) EP -- Retirement Plans ([www.irs.gov/ep](http://www.irs.gov/ep)):**

We believe an initial choice on EP landing page should be: Are you a “Plan Sponsor”, “Plan Participant”, or “Practitioner”. This choice would allow targeted access to material to interest to each.

Another initial choice we would recommend is the Life Cycle of a Retirement Plan (Table II). We believe this would serve as a good roadmap into basic materials for plan sponsors particularly.

We also have heard a strong demand to be able to be on this page and go directly to a specific item, e.g., Rev. Proc. 2002-4. We anticipate this would be most used by practioners.

As to a beginning list for "Contents," "Resources," and "Topics" we offer the following. We note that these recommendations depend on EP having ownership and control of all three segments (Contents, Resources, and Topics), which as noted above, seems to us to be critical to make this all “work.” We also note that we are not suggesting this as a rigid structure – we realize that as this is being developed certain items could shift in placement, importance, and desirability.

**(a) Employee Plan Contents**

- "Tool Box" for Plan Design
- Determination Letters

- Plan amendment information, alert guidelines, processing tips, white paper on possible alternatives to present determination letter system, forms, listing of required modifications.

- Examinations
- Correction Procedures
- Distributions/Taxation

**(b) Employee Plan Resources**

- EP Forms and Publications
- Employee Plan News
- Outreach Programs and Products
- Benefit Conferences Calendar (list of upcoming and recent events; narratives describing events)
- Pre-Approved Plans (list of approved master, prototype & volume submitter plans)
- Governing Law – direct link to Internal Revenue Code, ERISA, major laws affecting plans (e.g., EGTRRA), EP Regulations (link to text of law and committee reports)
- Technical Guidance (Revenue Rulings, Revenue Procedures, Notices, Announcements, etc.)
- Recent EP Releases/Developments
- Listing of Required Modifications
- EP FAQs
- EP Taxpayer Assistance (Call Site Information)
- Continuing Professional Education Text (current and prior years)

**(c) Employee Plan Topics**

We have inventoried possible topics in this section. However, we realize that some type of "drop down" feature may work better here. For example: "Qualified Plans," with a drop down feature that displays Defined Benefit Plans, 401(k) Plans, Employee Stock Ownership Plans, Other Defined Contribution Plans, etc. may make the most attractive user-friendly page.

- IRAs/SEPs/SIMPLEs
- Defined Benefit Plans [qualified 401(a) plans]
- Multi-Employer Plans

- Section 401(k) Plans
- Tax-Sheltered Annuities [403(b) programs]
- Defined Contribution Plans [401(a) plans]
- Deferred Compensation Plans [457 plans]
- Small Business Retirement Plans (presentation on retirement income, in-depth look at SEP, SIMPLE, Keogh and IRAs)
- Other Types of Plans
- Life Cycle of a Retirement Plan
- Disaster Relief Information (various published guidance concerning disaster relief)
- Listing of Required Modifications (information packages designed to assist sponsors)
- Participant Locator Services (“lost” plan participants)
- Limits on Contributions to Plans (415 limits, 401(a)(17) limits, elective deferral limits)
- Work Plan (current fiscal year EP program plan)

**(3) Federal, State & Local Government ([www.irs.gov/govts](http://www.irs.gov/govts)):**

**(a) FSLG Contents**

- Federal Government Agencies
- State/Local Government Agencies
- Quasi-Governmental Agencies
- FSLG Mission

**(b) FSLG Resources**

- Newsletter
- FSLG Forms/Publications
- FSLG Technical Assistance
- FAQs
- Letter Rulings
- Information Brochures
- FSLG Feedback

**(c) FSLG Topics**

- FSLG Calendar of Events
- Publication 963, Federal-State Reference Guide
- FSLG Outreach
- Current/Emerging Issues
- Filing Requirements

**(4) Indian Tribal Government ([www.irs.gov/tribes](http://www.irs.gov/tribes)):**

**(a) ITG Contents**

- About the ITG Division
- Regulations and Rulings

**(b) ITG Resources**

- ITG FAQs
- ITG Helpful Resources
- ITG Tax Kit
- News Releases and Announcements
- Forms and Publications
- Contacts -- ITG Division

**(c) ITG Topics**

- Educational Outreach Products
- ITG Current Issues
- List of Federally Recognized Tribes

**(5) Tax Exempt Bonds ([www.irs.gov/bonds](http://www.irs.gov/bonds)):**

**(a) TEB Contents**

- About the TEB Division
- Outreach, Planning and Review Program
- Voluntary Closing Agreement Program
- Examinations
- Current Regulations

**(b) TEB Resources**

- News Releases and Announcements

- Forms and Publications
- FAQ for Tax Exempt Bonds
- Glossary of TEB Terms
- Contacts -- TEB Division

**(c) TEB Topics**

- Filing Requirements
- PLRs, TAMs, and FSAs
- TEB Tax Kit
- CPE Articles
- Training Materials

**F. List Serves**

**(1) General Observations**

We also reviewed the idea of “directed communications” to customer segments. A new software package is being added by the IRS that could be used to set up subscription lists. Currently, items must be text message – URL access. The TE/GE staff believes there could be subject-based list-serves. We reviewed whether an individual could subscribe to various materials based on subject. We think the IRS should continue to pursue this as a possibility, as list serves are an efficient and cost effective tool for quick and timely information dissemination to a targeted audience. For example, on each division's landing page, customers could sign up to receive e-mails regarding releases on topics of interest to them that are specific to that division.

We acknowledge that questions exist with respect to maintaining lists, change of address staffing and incoming mail. However, we believe that responsibility can be given to subscribers to keep their addresses current with an easy update mechanism.

We recommend TE/GE develop the policy and procedures for the use of list serves by its divisions. We note the "Employee Plans News" approach as an excellent example for the EP population. The material is timely, potential subscribers can view the articles, and can decide whether to self-subscribe or unsubscribe. We urge consideration be given to additional self identification to allow directed information and coding, e.g., by topic, geographic location, etc.

**(2) Secondary Distribution**

We think there are ways to efficiently and effectively use "secondary" distribution routes, e.g., national conferences, newsletters of associations and large plans to

communicate information. We considered possible relationships with national associations or entities such as the US Chamber of Commerce, the Small Business Administration, large unions (e.g., NEA, UAW) and potential partnerships with them. Those organizations have newsletters, member web sites, and magazines that could effectively reach many people. For example, the National Council on Teacher Retirement e-mails its members on matters impacting teacher retirement plans, and then in turn NCTR members can communicate with their millions of participants. We believed that type of communication could be very effective. We urge TE/GE to actively solicit those groups to be on the list serve for applicable areas. We also urge encouragement of easy links from those associations' sites back to the IRS website. Section VI contains examples of such organizations.

### **(3) Tertiary Distributions**

In the course of discussions with EP personnel, we discovered there are also tertiary distribution routes potentially available. For example, many retirement systems and plan sponsors have member or employee newsletters. Those could be a wonderful, high affinity, high percentage readership distribution network.

#### **G. Protocols**

We recommend that TE/GE establish certain protocols for its websites. We fully appreciate that each TE/GE employee cannot have the ability to edit, add or subtract from the site. However, we think that in order for the site to be as dynamic and timely as we envision, consideration should be given to the following protocols:

- TE/GE control of the contents, resources and topics links on the left-hand side of each division's landing page.
- Items that have been approved through normal release channels should be made available immediately upon release for posting on the appropriate division's landing page.
- Entry of dated and time-driven material, e.g. publications, regulations, fact sheets and news releases, should occur within one day of issuance.
- "Corrections", for example, incorrect hours, phone numbers, should be made within two business days. Those corrections should be accomplished through a single contact. Multiple contacts should not be necessary.

## **IV. CALL SITE**

### **A. E-mail**

We believe TE/GE should consider expanding its possible uses of e-mail communications with its customers. We realize there are numerous issues associated with this, but we are convinced that at least a modest trial project should occur at the TE/GE call site to explore the problems, usage, usefulness and customer acceptance.

We acknowledge this calls into question staffing issues, as well as reliance questions. We envision this experiment being handled on a very controlled basis – communications with customers would be reviewed for quality and content. All such communications would have to formally acknowledge that the communication is not a ruling and is not binding, etc. This experiment may show that e-mail on an out-going basis is simply not feasible. It might demonstrate however that some use of e-mail for incoming purposes (e.g., form requests and comments) is helpful to both TE/GE and its customers.

## **B. Technical Improvements**

We have the following recommendations with respect to TE/GE call site improvements:

- TE/GE call site should have the ability to make direct transfer to the 1040 line. This could alleviate customer frustration in areas such as Roth IRAs, medical savings accounts, incorrectly connected call and misdirected calls.
- Before call site number is used as reference point in any new material or public announcements; ensure call site has notice and information in sufficient time to educate staff.

## **V. ADDITIONAL MATERIALS**

### **A. Primer Set of Materials**

Consider set of "primer" materials in each area.

#### **(1) EO**

- Publication 557 – This is in process with plans to produce a number of smaller publications targeted at EO customer groups and focused on three areas for each group: how to apply for exemption, filing requirements and recordkeeping, and required disclosures.
- Publication or article for trustees/directors about compliance responsibilities (like Elected Official's Guide).
- A publication or article on lobbying rules and reporting requirements for 501(c)(3) organizations.
- Revision and updating of Publication 598, a publication on unrelated business income.
- Update and revise Publication 1028 on churches.
- Publication on gaming.



- Online Form 1023/1024 that is “fillable” and printable.
- Publication 578, for private foundation managers was very helpful. We recommend considering an update project on it in upcoming work plans.

**(2) EP**

- CD Rom on 403(b)
- Basic pamphlets. In this section, we looked particularly at suggestions from the ACT Small Business Access and Compliance Project Group. Their suggestions include the following:
  - a plain language choice-of-plan manual on available programs for web site use and distribution
  - "how-to" manual for employers with qualified plans -- including checklists regarding what needs to be done to initially establish a retirement plan and administer it properly from year to year (as that Project Group noted, these checklists or manuals could be structured by type of plan (e.g., SEP, SIMPLE, 401(k), etc.).
  - pamphlet on payroll deduction IRAs.
  - publicize the new tax credit for small employer plan start up costs, user fee relief and tax credit for savers.

**(3) FSLG**

- Fact sheet on proper withholding and reporting procedures for back pay settlements.
- Fact sheet directed at federal agency responsibilities concerning information return reporting (e.g., Form 1099 or W-2).
- Fact sheet directed at state and local government responsibilities concerning information return reporting (e.g., Form 1099 or W-2).
- Fact sheet on employee vs. independent contractor.
- Fact sheet on elected and appointed officials as employees.
- Fact sheet on accountable expense allowance arrangements for governmental employers.

**(4) ITG** – In addition to cross-referencing the FSLG fact sheets applicable to ITG, the following ITG specific projects should be considered.

- Gaming Laws
- Tax Incentives Brochures (coordinated with HUD)
- Corporations Established under Tribal Law
- Trusts for Minors Established under Tribal Law

It should be noted that the ITG must coordinate many of their duties with other federal agencies. Therefore, ITG should consider developing joint primary materials (e.g., a money laundering brochure), whenever appropriate.

**(5) TEB**

- Basic compliance requirements for Governmental Bonds.
- Basic compliance requirements for 501(c)(3) Bonds.
- Basic compliance requirements for Other Private Activity Bonds.
- Basic compliance requirements for Indian Tribal Governmental Bonds.

## **B. Call Site Materials**

One initiative we undertook was to review whether call site guide materials would be helpful to TE/GE customers. In some areas, there are excellent materials available from technical staff that are currently being prepared for the call site staff. We interviewed each of the units about their materials and which they felt would be helpful. We also interviewed call site staff.

Following that review, we concluded the following:

EO – will work well to utilize call site "desk guide" (material prepared for the personnel at the call site).

EP – currently there are not separate scripts. The call site uses EP publications and instructions as their resource materials.

FSLG – FSLG call site materials are very basic and limited in scope. As such, the call site guide appears to not be adaptable for FSLG customer use.

ITG – probably will work to utilize "desk guide" from call site – recommend consider posting that on web site and then updating periodically.

TEB – probably will work to utilize "desk guide" from call site – recommend consider posting that on web site and then updating periodically. The best use of the call center for TEB, because of the unique customer base, is to identify which individual in TEB can properly address the question.

### **C. Newsletters**

The Employee Plans News has been very well received and we commend EP for the improvements and innovations in it. We recommend that EO consider whether a newsletter could work for the EO customers.

## **VI. EDUCATION AND OUTREACH PROGRAMS**

### **A. General Approach**

We believe outreach can most economically occur in significant part by (1) attending, presenting and/or forming informal information sharing partnerships with certain national associations or federal/state agencies, where both direct exposure and press coverage could serve to "get out the message" and (2) creating locally staffed and organized programs. We realize that education and outreach will also include indirect contacts through newsletters, publications, CDs, and videos.

We want to note several programs as successful innovations in each type of education and outreach that TE/GE has participated in the last several years:

- Nationally "driven" and staffed activities include the following:
  - Information Return Reporting Program
  - Wage Reporting Program
  - Section 403(b) Tax Sheltered Annuity Partnership for Compliance (a proactive customer education initiative to increase understanding and compliance for 403(b) programs). We realize that EP has planned to expand this "Partnership for Compliance" concept to 457 plans, multiple-employer plans and 401(k) plans. We strongly urge that necessary resources be devoted to these programs. All are areas where customer segments will benefit greatly and we think there would be significant "filter down" effects with press and other secondary coverage.
  - EP Benefit Conferences (sponsored or co-sponsored conferences), e.g., Great Lakes Benefits Conference, Mid-Atlantic Benefits Conference, and SWBA Benefits Conference. These have been very innovative, well received and very helpful to the practitioner

segment of EP. We commend the EP division for its innovations in this regard and urge continuation of these programs.

- EO program involving Section 527 requirements presented at Federal Election Commission conferences for political organizations.
- Western Conference on Tax-Exempt Organizations co-sponsored by Loyola Law School, Los Angeles and the Internal Revenue Service.
- Small and Mid-sized Exempt Organizations Workshops.
- Locally “driven” and staffed activities include the following:
  - A Federal State Educational Initiative for Kentucky's Public Employers – “2001 - A Payroll Tax Odyssey” a joint program involving the Internal Revenue Service (FSLG and EP), Social Security Administration, and the Commonwealth of Kentucky. Table XIII consists of the agenda and the first three pages of the program materials.

We also encourage consideration of when multilingual issuance is appropriate. We want to note in this regard EP’s savers tax credit notices issued this year in English and Spanish. That was incredibly helpful, particularly as those notices filtered through secondary distribution networks.

## **B. Federal and State Agency Partnerships**

The following federal agencies may provide TE/GE with the opportunity to develop educational partnerships:

- Social Security Administration
- Bureau of Indian Affairs
- Small Business Administration
- Department of Justice
- Office of Personnel Management
- Department of Labor
- Department of Agriculture
- Federal Management Service
- Equal Employment Opportunity Commission
- Federal Election Commission
- Securities and Exchange Commission
- National Association of State Charity Officials
- National Association of Attorneys General

➤ Housing and Urban Development

TE/GE may, in addition to working with the identified national public associations listed below, find educational partnership opportunities working with state government agencies, statewide public employer associations, and public employee unions. For example, public retirement systems, state educational associations, state social security administrators, state departments of education, state municipal leagues, etc. may all provide ways to organize locally driven activities.

**C. Secondary Distribution Networks**

We believe the following organizations should be explored as likely secondary distribution candidates. TE/GE may find these organizations as possible sources for exploring possible Web links, as well as including information and releases from TE/GE in their newsletters, member publications, resource listings, etc. These associations are also an efficient means of quickly disseminating new information to a large number of people and organizations. Most of these associations are looking for items of interest for their constituents. Should the IRS notify (e.g., via e-mail) of a new release, such as a revenue procedure, these associations would likely publish the information in their newsletters with a link to the IRS web site. This will not only provide timely dissemination of information, but will also increase the number of people that visit the IRS web site. Hopefully, a new visitor will find additional information of interest to them.

**(1) National Associations for EO:**

- American Society of Association Executives
- Association of Fund Raising Professionals
- BBB Wise Giving Alliance
- Board Source
- Council for American Private Education
- Council on Foundation
- Independent Sector
- National Association of College and University Business Officers
- National Charities Information Bureau
- National Council of Non-Profit Associations
- National Society of Fund Raising Executives
- Philanthropic Research, Inc. (a/k/a GuideStar)
- The Foundation Center
- Urban Institute

**(2) National Associations for EP:**

- American Association of Retired Persons
- American Savings Education Council
- American Society of Pension Actuaries
- Conference of Consultants
- Defined Plan Coalition Coordinating Council
- Employee Benefits Research Institute
- Employers Council on Flexible Compensation
- Enrolled Actuary Annual Meeting
- International Foundation of Employee Benefit Plans
- National Association for Retirement Systems Administrators
- National Association of Public Pension Attorneys
- National Conference on Public Employee Retirement Systems
- National Council on Teacher Retirement
- Pension Rights Center
- Profit Sharing Council
- Tax Executive Institute

**(3) National Associations for FSLG:**

- American Institute of Governmental Accountants
- Association of Government Accountants (AGA)
- Government Finance Officers Association
- National Association of State Auditors, Comptrollers, and Treasurers
- National Association of State Comptrollers
- National Conference of State Social Security Administrators

**(4) National Associations for ITG:**

- National Congress of American Indians
- National Indian Gaming Association
- Native American Finance Officers Associations
- United South and Eastern Tribes
- Affiliated Tribes of Northwest Indians

- Midwest Alliance of Sovereign Tribes
- Inter-Tribal Council of the Five Civilized Tribes

**(5) National Associations for TEB:**

- Government Finance Officers Association
- National Association of Bond Lawyers
- National Association of Counties
- National Association of State Treasurers
- National League of Cities
- National Association of Counties
- American Association of School Administrators
- Municipal Securities Rulemaking Board

It should be noted that the TEB Outreach group has already developed a comprehensive list of over 20 associations and market participant groups and has assigned specific individuals to coordinate the outreach efforts with those organizations. The listing above is a sample of the organizations already identified by TEB.

**(6) Additional Associations Covering Several Divisions:**

- American Bar Association (appropriate committees)
- American Federation of Teachers
- American Institute of Certified Public Accountants (AICPA)
- National Association of College and University Business Officers (NACUBO)
- National Association of School Business Officers (NASBO)
- National Education Association

## **VII. ACKNOWLEDGMENTS**

We would like to acknowledge the spirit of enthusiasm and openness that TE/GE staff demonstrated in all our contacts with them. They evidenced creativity and innovation throughout our time with them. It was truly a pleasure to work with each of them and we are grateful for their candid comments and observations. Table XII lists our primary resources within TE/GE.



## Charities & Non-Profits

**Search**

**Forms and Publications Finder**

**Search Help**

**contents**

- Life Cycle of a Public Charity
- Types of Tax Exempt Organizations
- Donor Information
- Reporting
- Lobbying Expenditures Reports

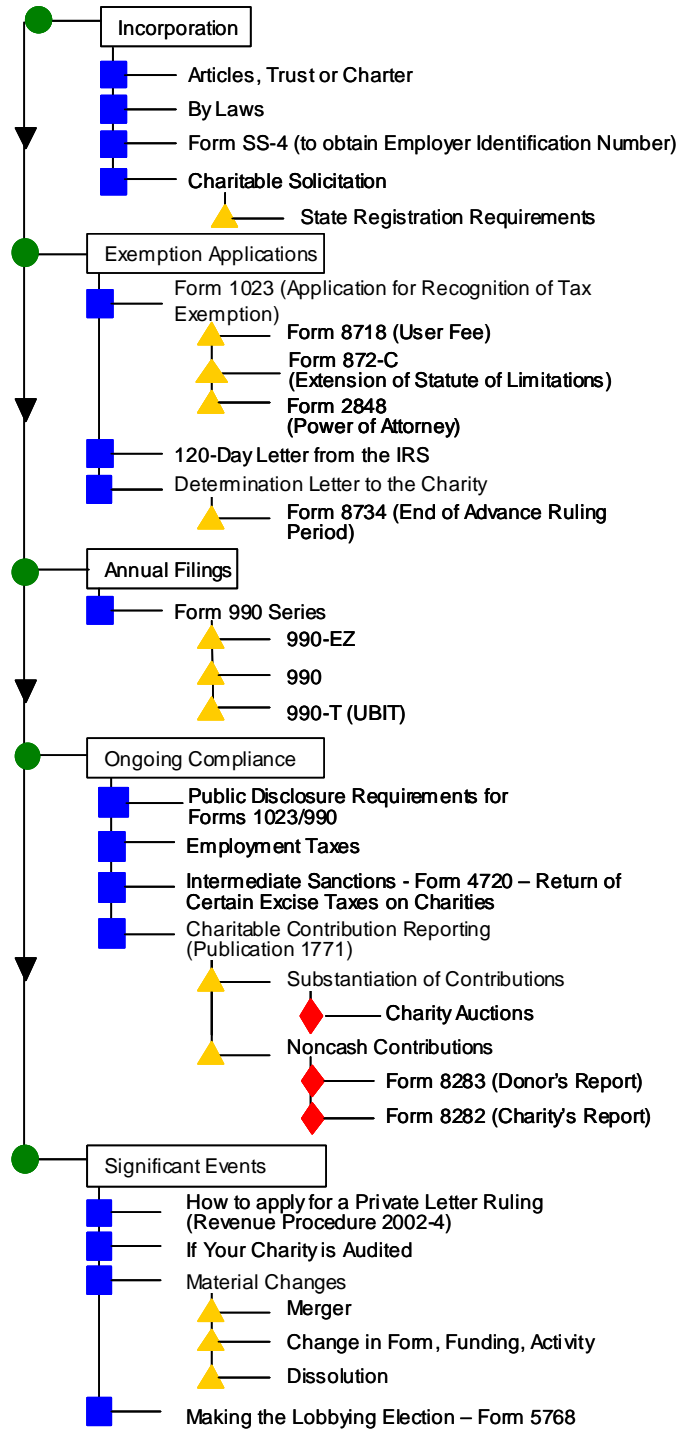
**resources**

- EO Tax Kit
- EO Customer Account Services
- Publication 78, Search for Tax Exempt Organizations
- EO Forms and Publications
- EO FAQs
- EO Taxpayer Assistance
- List of Contact Numbers for State Secretary of State Offices and State Sales Tax Offices

**topics**

- EO Application Process
- EO Calendar of Events
- EO in Depth
- EO Public Disclosure Requirements
- Exempt Organization Statistics
- Field Memoranda
- Filing Tips
- Publication 557, Tax Exempt Status for Your Organization
- Lobbying rules and reporting requirements for 501c3s
- Tax Topics
- Tax Treaty Information
- Unrelated Business Income Taxes
- Charitable Contributions: Substantiation and Disclosure
- Disaster Relief
- What is Tax Deductible?
- 527 Organizations

### Life Cycle of a Public Charity



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## Employee Plans

### Search

### Forms and Publications Finder

### Search Help

### contents

- “Tool Box” for Plan Design
- Determination Letters
- Examinations
- Correction Procedures
- Distributions/Taxations

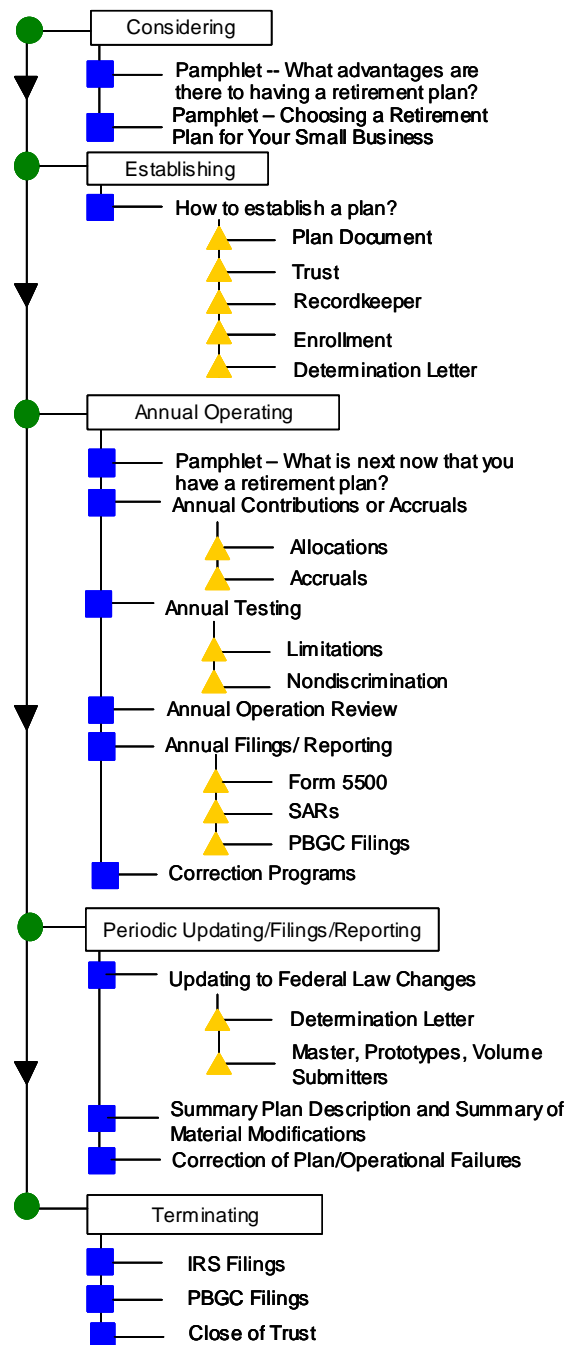
### resources

- EP Forms and Publications
- Employee Plan News
- Outreach Programs and Products
- Benefit Conferences Calendar
- Pre-Approved Plans
- Governing Law
- Technical Guidance
- Recent EP Releases/Developments
- Listing of Required Modifications
- EP FAQs
- EP Taxpayer Assistance
- Continuing Professional Education Text

### topics

- IRAs/SEPs/SIMPLEs
- Defined Benefit Plans
- Multi-Employer Plans
- Section 401(k) Plans
- Tax-Sheltered Annuities
- Defined Contribution Plans
- Deferred Compensation Plans
- Small Business Retirement Plans
- Other Types of Plans
- Life Cycle of a Retirement Plan
- Disaster Relief Information
- Listing of Required Modifications
- Work Plan
- Participant Locator Services
- Limits on Contributions to Plans

### Life Cycle of a Retirement Plan



May 2002

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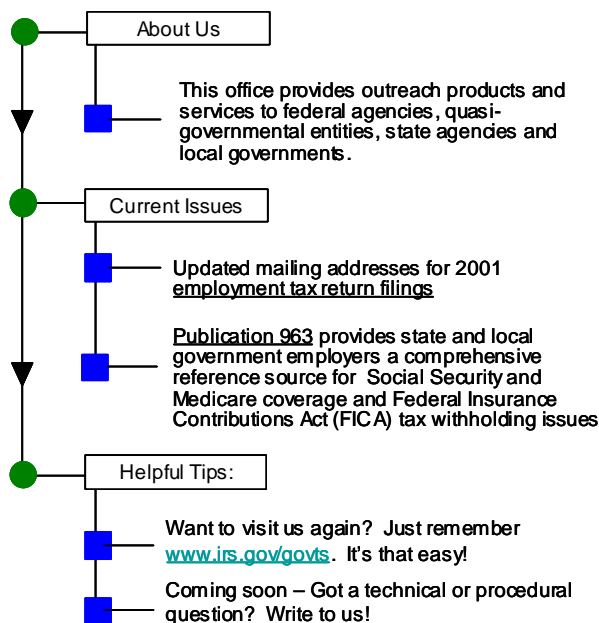
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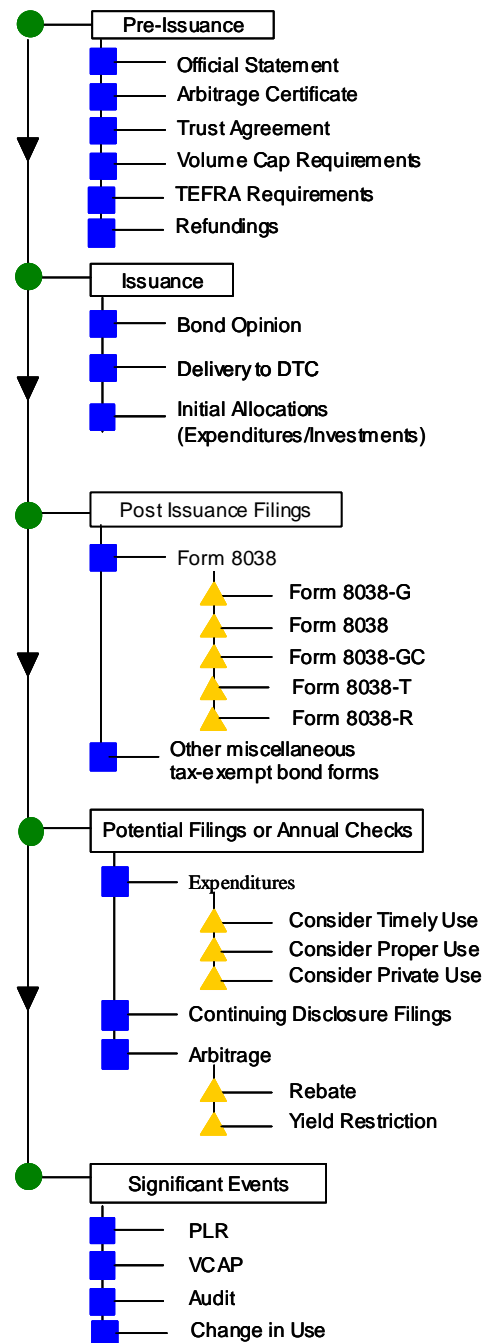
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### Life Cycle of a Bond Issuance



May 2002

## **TABLE V**

### **INVENTORY OF EXISTING MATERIALS – EO**

**(Does not include forms, formal guidance, regulations, revenue rulings, revenue procedures, etc.)**

#### **The following publications now exist**

- Publication 557, *Tax Exempt Status for Your Organization* (being revised; listed under publications in process)
- Publication 1828, *Tax Guide for Churches and Religious Organizations* (being revised; listed under publications in process)
- Publication 3079, *Gaming Publication for Tax Exempt Organizations* (being revised; listed under publications in process)
- Publication 578, *Tax Information for Private Foundations and Foundation Managers*
- Publication 598, *Tax on Unrelated Business Income of Exempt Organizations*
- Publication 3386, *Veteran's Organizations*
- Publication 1771, *Charitable Contributions: Substantiation and Disclosure*

#### **The following publications are in process**

- Church Publication – Churches are not required to apply for exempt status or file Forms 990. However, as exempt organizations, they and other religious organizations are subject to various tax rules. To explain these rules and exceptions, CE&O will produce an updated version of the Church Publication.
- Donated Vehicles – Soliciting donations of cars and other assets has become a popular fundraising technique. Unfortunately, if not handled properly, these activities can raise compliance issues. CE&O will coordinate with other EO staff and state charity officials to help exempt organizations avoid problems raised by vehicle donation programs.
- Should My Organization Apply for Tax Exempt Status? – CE&O will prepare a "beginner" brochure explaining "pros" and "cons" of exemption for organizations that are considering applying for tax exemption.

- Publication 557, Tax Exempt Status for Your Organization – Pub. 557 discusses the rules and procedures for all 501(a) exempt organizations that seek to obtain recognition of exemption under the federal income tax code. CE&O will review the publication to determine how to make it easier to use. (Also link to Life Cycle)
- Gaming Publication for Tax Exempt Organizations – Minor changes will be made to update this publication.

**The following publications are in the planning stages**

- Precautions to Take When Making a Charitable Contribution – Concerns have been raised about certain fundraising activities. We will work with the Wage & Investment Division, state charity officials, and outside stakeholders to develop a pamphlet to help prospective donors.
- 527 Political Organizations – Significant new legislation affecting 527 organizations was passed in 2000. CE&O will develop a brochure describing the tax rules pertaining to these organizations.
- Dos and Don'ts for Exempt Organizations – CE&O will prepare a brochure covering "basic" steps exempt organizations should take or avoid.

**TABLE VI**

**INVENTORY OF EXISTING MATERIALS – EP**

**(Does not include forms, formal guidance, regulations, revenue rulings, revenue procedures, etc.)**

- Publication 535 – Business Expenses
  - Status:
  - Description:
  
- Publication 560 – Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans)
  - Status:
  - Description:
  
- Publication 571 – Tax-Sheltered Annuity Plans (403(b) Plans) for Employees of Public Schools and Certain Tax-Exempt Organizations
  - Status: Last updated January 2002
  
- Publication 575 – Pension and Annuity Income
  - Status: Last updated January 2002
  - Notice 1269 – Supplement to Publication 575
  
- Publication 590 – Individual Retirement Arrangements (IRAs)
  - Status: Last updated January 2002
  - Notice 1270 – Supplement to Publication 590
  
- Publication 794 – Favorable Determination Letter
  - Status:
  
- Publication 939 – General Rule for Pensions and Annuities
  - Status:
  
- Publication 963 – Federal-State Reference Guide (Social Security Coverage and FICA Reporting by State and Local Governmental Employers)
  - See FSLG inventory (Table VII)

**TABLE VII**

**INVENTORY OF EXISTING MATERIALS – FSLG**

**(Does not include forms, formal guidance, regulations, revenue rulings, revenue procedures, etc.)**

- Federal-State Reference Guide (Social Security Coverage and FICA Reporting by State and Local Government Employers) – Publication 963 (Rev. 10-97)
  - Status: Last updated October 1997 (currently under revision)
  - Description: The Federal-State Reference Guide provides State and local government employers a comprehensive reference source for Social Security and Medicare coverage, withholding and reporting issues

Also available are the FSLG Bookmark and Introductory Tri-fold.

**TABLE VIII**

**INVENTORY OF EXISTING MATERIALS – ITG**

**(Does not include forms, formal guidance, regulations, revenue rulings, revenue procedures, etc.)**

- Name: Introduction to Indian Tribal Governments. [Publication 3747 (6-2001)]
  - Status: Inaugural edition printed in June 2001
  - Description: This is an introductory tri-fold brochure describing the new office of Indian Tribal Governments at the IRS. Brochure discusses the education and customer service available from the ITG Division.
  - Availability: Print, web site

Also available are an Indian Tribal Government Bookmark and Introductory Tri-fold.



**TABLE IX**

**INVENTORY OF EXISTING MATERIALS – TEB**

**(Does not include forms, formal guidance, regulations, revenue rulings, revenue procedures, etc.)**

- Tax Exempt Bond Technical Instruction Program for FY 2002. [Training 4233-01 (8-2001)]
  - Status: Inaugural edition printed in August 2001
  - Description: This is a comprehensive 352-page book covering 20 separate topics for tax-exempt bonds. This document serves as a training tool for agents and customers and is designed to “facilitate our customers in locating CPE articles that address their technical needs.”
  - Availability: Print, web site
  
- Tax Exempt Bonds – Filing Requirements. [Publication 3755 (5-2001)]
  - Status: Inaugural edition printed in May 2001
  - Description: This 5-page brochure provides an overview of the forms that must be filed in connection with tax-exempt bonds and their related due dates.
  - Availability: Print, web site

**TABLE X**

**FUTURE PUBLICATIONS – ITG**

The Indian Tribal Government Division has a number of planned publication in process, including:

- Gaming brochure (expected for FY 2002)
- Desk Reference Guide (Web-based)
- Tip Compliance
- Indian Tribal Governments calendar with key reporting dates.

**TABLE XI**

**FUTURE PUBLICATIONS – TEB**

The Tax Exempt Bond Division has a number of planned publication in process, including:

- Primer for Governmental Bonds (first draft completed)
- Primer for 501(c)(3) Bonds
- Introductory Tri-fold and Bookmark
- Voluntary Closing Agreement Program Pamphlet
- Small Issue Bond Pamphlet
- Indian Tribal Government Pamphlet
- Single/Multi-Family Housing Bonds Pamphlet
- Leases Pamphlet
- Commercial Paper Pamphlet
- Registration Requirement Pamphlet
- Continuing Professional Education Textbook for FY 2003

**TABLE XII**

**PRIMARY INTERNAL RESOURCES WITHIN TE/GE**

**EO**

Steve Miller, Director Exempt Organizations (202-283-2300)  
Roberta Zarin, Director Customer Education & Outreach (202-283-8868)

**EP**

Peter M. Conkey, Staff Assistant Customer Education & Outreach (202-283-9531)  
Carol Gold, Director Employee Plans (202-283-9515)  
Mark O'Donnell, Director Customer Education & Outreach (202-283-9532)  
Nancy E. Payne, Senior EP CE & O Analyst (202-283-9551)  
Paul Shultz, Director EP Rulings and Agreements (202-283-9660)  
Richard Westley, Executive Assistant (202-283-9513)

**FSLG**

Allen Jones, Director Federal/State/Local Governments (202-283-9818)  
Charles Peterson, Director Governmental Entities (202-283-2900)  
William Reed, Manager FSL Outreach Planning & Review (202-283-9799)  
Ed Weiler, Director Governmental Entities (202-283-2900)

**ITG**

Christie Jacobs, Director Indian Tribal Governments (202-283-9736)

**TEB**

Cliff Gannett, Manager TEB Outreach Planning & Review (202-283-9798)  
W. Mark Scott, Director Exempt Bonds (202-283-9820)

**Other**

Donna Carlisle, Staff Assistant, TE/GE, Customer Account Services  
Venita Gardner (202-283-9754)  
Sarah Hall Ingram (202-283-9897)  
Steve Pyrek, Director Communication & Liaison (202-283-9966)  
John E. Ricketts, Director, Customer Account Services  
Thomas D. Terry, Senior Technical Advisor (202-283-9840)

**TABLE XIII**

**FEDERAL STATE EDUCATIONAL INITIATIVE**



**2001-- A  
Payroll Tax Odyssey**

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***KENTUCKY***  
*Leading the Way*

*2001-- A Payroll Tax Odyssey: A Federal-State Educational Initiative for Kentucky's Public Employers.*

Social Security Administration  
Internal Revenue Service  
Kentucky Division of Social Security  
Kentucky Department for Local Government  
Kentucky Retirement System

# 2001 -- A Payroll Tax Odyssey

A Federal-State Educational Initiative for Kentucky's Public Employers

**8:45 am - 9:15 am**      Kentucky Department for Local Government 

**9:15 am - 10:10 am**      Internal Revenue Service  
(TE/GE: Government Entities) 

**10:10 am - 10:25 am**      Break


**10:25 am - 10:55 am**      Kentucky Division of Social Security 

**10:55 am - 11:25 am**      Social Security Administration 

**11:25 am - 11:55 am**      Kentucky Retirement System 

**12 noon - 1 pm**      Lunch

*Afternoon Session for Education Agencies Only*

**1 pm - 3 pm**      Internal Revenue Service  
(TE/GE: Employee Plans) 

In a joint effort, representatives from the Kentucky Division of Social Security, Social Security Administration, Internal Revenue Service, Kentucky Retirement System and Kentucky Department For Local Government conducted payroll seminars for representatives of state and local government employers during October 2001. This is the first such joint federal-state educational initiative in the nation that has included state government, SSA and two components from the IRS Tax Exempt and Government Entities Division.

In order to minimize the distance any participant had to travel, twenty-two sites were selected throughout the state to host the seminars. Participation at the seminars was excellent.

- There were 970 attendees at the seminars;
- Attendees represented Kentucky's employers that report Forms W-2 for over 265,000 employees – out of a total of 335,000 employees;
- Payroll managers attending one of the seminars represented seventy-one percent of all Kentucky state and local employees;
- A representative from every university in Kentucky attended one of the seminars;
- 84% of Kentucky boards of education, 77% of the state's largest cities and 68% of Kentucky counties were represented at the seminars.
- 612 of the local government entities that are included under Kentucky's Section 218 agreement with the Social Security Administration sent representatives to the seminars.

The quality and content of instruction was superior. Information contained in the seminars was of such high caliber to allow continuing education credit (CEU) and continuing professional education (CPE) to be given by the Kentucky Department of Education, Department for Local Government, Department of Libraries and the State Board of Accountancy.

The seminars were an overwhelming success. They provided the vehicle for the state and local payroll employees to obtain information pertaining to social security coverage, tax changes for 2001, develop a stronger relationship with federal/state representatives and view computer hands-on demonstrations. The seminars provided participants with the tools needed to be successful in preparing wage reports for the Social Security Administration, Internal Revenue Service and Kentucky Department of Revenue. We expect Kentucky's state and local payroll agents to lead the nation in proper coverage determinations, correct payroll tax administration, appropriate employment tax withholding, accurate wage reporting and utilization of electronic filing.

### **Development of the Seminars**

The Kentucky Division of Social Security took the lead with the seminars and began developing and planning the seminars in March 2001. Site locations were

determined based on centralized, regional locations allowing for participants to travel short distances to attend a seminar. Expense of location was also taken into consideration (most of the locations were free or charged only a nominal amount). Total cost for rental of the locations was approximately \$1,375.

Letters of invitation were sent to public payroll officers beginning in September 2001. The letters gave information about the seminars and asked participants to register via telephone or e-mail. Those entities that did not respond were called and urged to attend.

The seminars were also advertised via several state web sites (Kentucky Division of Social Security, Department of Education, Division of Conservation, Department for Local Government, Kentucky Association of Counties), several state agency newsletters and at various local governmental association meetings.

Seminar participants met as a group on 09/19/01 to finalize the conduct of the seminars. Representatives from the all the federal and state partners were present. The seminar agenda, topics to be covered, time to be allocated to each speaker and logistical arrangements were discussed and finalized. An evaluation form of the presenters was also drafted.

#### **ENTITY TYPES THAT ATTENDED THE SEMINARS**

- **Cities**
- **Area Development District**
- **Civil Defense Agency**
- **Conservation District**
- **Educational Cooperative**
- **Fire District**
- **Health Department**
- **Housing Authority**
- **Library**
- **Planning Commission**
- **Riverport Authority**
- **State Agency**
- **Transit Authority**
- **Urban County Government**
- **Utility**
- **Airport Board**
- **Board of Education**
- **Community Action Agency**
- **County**
- **Emergency Medical Service**
- **Garbage District**
- **Hospital**
- **Industrial Authority**
- **Park Board**
- **Police**
- **Sanitation District**
- **Tourist Commission**
- **University**
- **Urban Renewal Agency**
- **Water District**



**ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**III. TRIBAL CONSULTATION POLICY  
PROJECT GROUP**

DAVID MULLON, PROJECT LEADER  
JAYNE FAWCETT  
PERRY ISRAEL

JUNE 21, 2002

## **RECOMMENDED PROCESS FOR THE INTERNAL REVENUE SERVICE TO FOLLOW IN DEVELOPING A TRIBAL CONSULTATION POLICY**

“Consultation is an enhanced form of communication that emphasizes trust, respect and shared responsibility. It is an open and free exchange of information and opinion among parties that leads to mutual understanding and comprehension. Consultation is integral to a deliberative process that results in effective collaboration and informed decision making.”

— “Consultation” defined in Department of Health and Human Services’ Plan For Tribal Consultation

“‘Consultation’ means a process of government-to-government dialogue between the Bureau of Indian Affairs and Indian tribes regarding proposed Federal actions in a manner intended to secure meaningful and timely tribal input<sup>1/4</sup>. Consultation does not mean merely the right of tribal officials, as members of the general public, to be consulted, or to provide comments, under the Administrative Procedures Act or other Federal law of general applicability.”

—From the Bureau of Indian Affairs’ “Government-to-Government Consultation Policy” applicable to American Indian Tribes

“This Administration honors the commitment this nation made in 1970 [when President Richard M. Nixon announced his new national policy of self-determination for Indian tribes] and 1975 [when the President signed into law P.L. 93-638, the Indian Self-Determination and Education Assistance Act] to strengthen tribal governments and lessen federal control over tribal government affairs. *This Administration is determined to turn these goals into reality. Our policy is to reaffirm dealing with Indian tribes on a government-to-government basis and to pursue the policy on self-government for Indian tribes without threatening termination.*”

—From President Ronald Reagan’s statement on federal Indian policy, January 24, 1983. (Emphasis added.)

## I. INTRODUCTION.

Commencing with the Environmental Protection Agency in 1984<sup>1</sup>, several departments and agencies of the Federal Government have adopted Tribal consultation policies applicable to the formulation, planning and implementation of Federal projects, programs, policies and other actions that might affect one or more of the 559 federally-recognized Indian or Alaska Native tribes, bands, nations, pueblos, villages and communities (collectively, “Tribes” or “Tribal Governments”).<sup>2</sup> Although differing in many respects, all of these policies expressly acknowledge the unique government-to-government relationship that exists between the United States and each one of these Tribes. Most if not all of these policies acknowledge their basis in the U.S. Constitution, treaties, federal statutes, Supreme Court decisions and executive orders and policies that, taken together, establish the foundation for the unique relationship between the U.S. Government and the Tribes.

At the conclusion of the first meeting of the Advisory Committee on Tax Exempt and Government Entities (the “Committee”) held on June 25-26, 2001, the Committee observed that the Internal Revenue Service (the “Service”) lacked a formal Tribal consultation policy and that, as have the many other Federal agencies that have frequent dealings with Tribal Governments, the Service should develop such a policy.

The Committee agreed to adopt this specific project—recommending to the Service a process or a series of steps to follow in developing a Tribal consultation policy—rather than designing and recommending the consultation policy itself for a number of reasons. The members of the Tribal Consultation Project Group<sup>3</sup> suggested that a successful tribal consultation policy should itself be the product of meaningful consultation with the Tribal Governments to which it would apply. This is so because the extent of cultural and organizational diversity among Tribes and their governing bodies is significant, and because many Tribes have limited experience interacting with agencies of the Government that, historically, have not been active in Indian affairs. In addition, we believe that by engaging the Tribes in the process of developing a consultation policy, the Service would be demonstrating from the outset that it has embraced the principle of government-to-government dealings with the Tribes and would thereby increase the likelihood that the Service’s consultation policy will be

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<sup>1</sup> See *Environmental Protection Agency’s Indian Policy adopted by EPA Administrator William D. Ruckelhaus on November 8, 1984*. EPA Administrator Christine Todd Whitman expressly reaffirmed the 1984 Tribal Consultation Policy on July 11, 2001.

<sup>2</sup> See, e.g., Department of Energy “*American Indian Tribal Government Policy*,” first issued on April 8, 1992, and updated as the Department’s “*American Indian and Alaska Native Tribal Government Policy*” on October 31, 2000; Department of Justice “*Policy on Indian Sovereignty and Government-To-Government Relations with Indian Tribes*,” adopted June 1, 1995; General Services Administration “*Policy Toward Native American and Alaskan Tribes*,” adopted November 17, 1999; and Department of Interior, Bureau of Indian Affairs “*Government-To-Government Consultation Policy*,” adopted December 13, 2000.

<sup>3</sup> Jayne Fawcett, Perry Israel and David A. Mullon Jr.

perceived as a genuine expression of its commitment to that principle.<sup>4</sup> Accordingly, the Committee feels that a careful “scoping” of potential issues and concerns with regard to federal tax matters and an effort to make direct contact with as many as possible of the hundreds of federally recognized Tribes are essential to the formulation of an effective, informed Tribal consultation policy.

#### RECOMMENDED STEPS FOR DEVELOPING A TRIBAL CONSULTATION POLICY.

The Service should take the following steps in the course of developing a Tribal consultation policy: (1) give notice to all Tribes of its intent to adopt a Tribal consultation policy and conduct regional “scoping” or consultation meetings; (2) conduct a series of regional consultation meetings; (3) prepare and circulate a proposed consultation policy and receiving Tribal comments thereon; and (4) adopt the policy.

##### A. Give notice of intent to adopt policy and conduct regional meetings.

As the first step in the process of developing a Tribal consultation policy, the Service should prepare a clearly written statement or announcement that it intends to adopt a Tribal consultation policy and that it will conduct a series of regional consultation or scoping meetings in order to discuss such a policy with tribal leaders and representatives and receive their comments and recommendations for the policy. The Committee recommends that the Service conduct a scoping meeting in the city or town of the Bureau of Indian Affairs regional office in each of the twelve BIA administrative regions, and that a schedule of the meeting dates be communicated to the leaders of all Tribes as far in advance as possible. The announcement of the Service’s intent to develop a Tribal consultation policy and the schedule of meeting dates should be sent to Tribes and Indian organizations by mail, email and facsimile, published in the Indian press, and posted on the IRS website. The Service should also consider seeking assistance from national Indian organizations in disseminating its statement of intent to develop the policy, in scheduling and, if possible, conducting regional scoping meetings, and in preparing meeting agendas.

##### Conduct scoping meetings before preparing a draft policy.

The scoping meetings should be used to solicit written and oral comments and suggestions from Tribes and Indian organizations on what should be included in an IRS Tribal consultation policy as well as on how the Tribes would like to collaborate in the formulation of the policy.<sup>5</sup> Each meeting should be conducted in accordance with a

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<sup>4</sup>The Committee does not intend to suggest here the content or wording of the policy or the matters that it should address. The content of the policy, including without limitation the various kinds of Service actions and activities that should be undertaken only after meaningful tribal consultation, should be addressed by the Service and the Tribes as the policy is being developed pursuant to the recommendations in this report.

<sup>5</sup> It is possible, for example, that the Tribes may recommend the formation of a joint federal/Tribal committee or a Tribal leaders task force to work on the policy. If so, the members representing the Tribes on such a committee or task force should be selected by the Tribes themselves. Use of a committee or task force can be an efficient vehicle for receiving input from Tribes, and either would be something that the Tribes are familiar with. The Federal Advisory Committee Act, 5 U.S.C. App.2., would

written agenda which should be distributed well in advance of the meeting and, in addition to any presentations to be made by Government representatives, should provide ample opportunity for Tribal representatives to speak and present their views on what the policy should include and/or address. Attendees should be encouraged to submit written comments at any time during the meeting or within a reasonable time following the meeting; therefore, addresses for mailing or emailing comments to the Service should also be made available.

C. Prepare and distribute a draft consultation policy.

After receiving comments from Tribes and/or any joint Federal/Tribal committee, Tribal leaders task force, or workgroup designated by the Tribes, the Service should prepare and make available to Tribes and tribal organizations a draft of the proposed policy and a notice of opportunity to submit comments on and/or proposed changes to the draft policy within a clearly stated time. The notice should include, in addition to the deadline for submitting comments and/or proposed changes, the name of the Government office responsible for receiving comments and proposed changes and the address to which comments should be mailed. If feasible, comments should be accepted via email as well, in which case an email address should be stated in the notice. Copies of the draft policy and the notice should be mailed, sent by facsimile and email to the Tribes and Indian organizations and should be made available for review/downloading on the IRS website further comment and input prior to adopting a final policy.

D. Adopt and distribute a final consultation policy.

After reviewing and evaluating any comments received from Tribes, Indian organizations and other interested parties, the Service should adopt a formal Tribal consultation policy. The final policy should be disseminated as described in paragraph C, above.

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*probably not apply to such a committee or task force. See 2 U.S.C. §1534(b). Again, national or regional Indian organizations should be considered for assisting in the creation of any such committee, task force or workgroup and coordinating its work. If, early in the process, there appears to be a clear consensus among the Tribes that a task force approach is preferable to the series of regional meetings recommended here, or that a task force approach should be used along with the regional meetings, the Service should defer their collective judgment.*

**ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**IV. VOLUNTARY CORRECTIONS  
PROJECT GROUP**

PERRY ISRAEL, PROJECT LEADER  
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DONALD J. SEGAL  
DON F. WAUGH

JUNE 21, 2002

## **Advisory Committee on Tax Exempt and Government Entities Voluntary Correction Programs**

### **I. Scope of Report**

#### ***Focus***

This report focuses on how TE/GE can increase the opportunities for customers to voluntarily correct compliance problems.

The TE/GE customer base includes sponsors of employee retirement plans, charitable organizations and religious organizations, tax-exempt bond issuers, and state, local and tribal governments. These customers have issues relating to compliance that vary substantially. In addition, many of the different constituencies in the customer base are relatively new to any Service-initiated compliance and audit process. It is necessary to take each step in the development of a compliance and correction program carefully, giving full weight to customer differences.

We also note that the resources of TE/GE will never be sufficient to implement a compliance program driven solely by audits. Nor is it obvious that such an audit-driven program would be deemed acceptable to governmental entities that are TE/GE customers. Accordingly, we believe that TE/GE needs to continue to develop programs oriented toward taxpayer self-review and correction. Nonetheless, we recognize that our emphasis on the need for significantly expanded corrections programs in EO, TEB, FSLG and ITG is likely to impose additional resource demands. We hope that TE/GE will be able to draw on the personnel and expertise in the EP voluntary compliance programs to help satisfy that demand.

Specifically, this report focuses on correcting problems arising after the activity that brings the customer under the scope of TE/GE:

- Employee Plans (EP) — after adoption of a plan
- Exempt Organizations (EO) — after granting of exemption
- Tax-Exempt Bonds (TEB) — after issuance of bonds
- Governments (FSLG and ITG) — after employment of individuals

#### ***TE/GE Mission***

Part of the TE/GE mission is to help TE/GE customers comply with applicable federal tax rules. For EP, EO, and TEB, TE/GE helps organizations or borrowers operate their programs in a manner consistent with the reason for the legislated tax treatment of the plan, organization, or bonds. For FSLG and ITG, TE/GE's role is to provide a proper interface between the Internal Revenue

Service and federal, state, local, and tribal governments in their roles as employers or information reporters, but with deference for comity and sovereignty. TE/GE is not a major revenue center, in that it has a very limited obligation to assess or collect taxes, limited largely to employment and excise taxes.

### ***Goal of Voluntary Compliance and Correction***

The goals of voluntary compliance and correction are as follows:

- Encourage compliance with applicable federal tax laws
- Encourage customers of TE/GE to operate consistently with their tax-exempt status (or, in the case of Indian Tribes and federal, state, and local governments, status as entities not subject to tax)
- Provide increased satisfaction to both customers and TE/GE
- Better utilize public resources

## **II. Basic Parameters of Voluntary Corrections**

### ***Key Elements of Successful Compliance***

A successful compliance program involves a number of elements:

Established Law and Principles — Voluntary compliance programs are much easier to implement in the context of situations where everyone agrees on what the law is. Voluntary compliance is much more difficult to apply in situations where new guidance is being developed or in areas where there is little or no agreement on what standards apply. Accordingly, the development of voluntary correction/compliance programs goes hand-in-hand with the development of additional guidance and even with the development of policy decisions.

Education/Communication — Both general education of customers as to law and specific education as to common problem areas are needed.

Self-Audit and Self-Correction — The program should encourage customers to identify problems and correct them (either retroactively or prospectively, depending upon the circumstances). Some problems should be correctable without Service intervention; others may require some involvement of the Service.

Enforcement Audits An audit program should be designed to provide the Service the ability to identify problems and make sure customers are complying. A successful compliance program necessarily has some teeth.



Feedback — Problems that are regularly discovered on audit or self-examination should help direct both the development of additional guidance and the content of the education program. In addition, they may also provide direction for further development of the self-audit and self-correction program. Because of the limits on ability to enforce by audit inherent in resource constraints and in what is acceptable to customers of the IRS, we believe the goal of the overall program should be to make the tax structures more self-policing, with audits serving to check on compliance, ensure conformity, and provide information to better serve the policies promoted by the tax-exemption. One corollary of this view is that audit programs should not be viewed as either (a) punitive (except for egregious cases of either blatant noncompliance or reckless disregard to compliance) or (b) a vehicle for the development of substantive law.

Build on Past Successes. — TE/GE has worked progressively for a number of years to develop voluntary compliance program in EP. This program has a number of extremely successful attributes, some of which are reflected in recommendations for other areas. (We also believe that the program for EP can be made better and have specific suggestions for the existing EP program.) The evolution of this successful program required that the Service listen to its customers and practitioners with the objective of continually revising and improving the program.

### ***Principles Supporting a Successful Program***

We believe that to be effective and successful, a voluntary corrections program should incorporate the following:

Consistency and Uniformity — Similarly situated customers must be treated similarly.

Substantial Public Input — Given the relative newness of compliance programs in many areas, the possible suspicion on the part of the customers, and the need to develop standards for compliance in many areas, TE/GE needs to involve its customers and industry participants substantially in the development of programs. The Service must remain open-minded to continual quality improvements in programs (including the flexibility to change parts of the program that are not working). One point that can be easily observed is that, where the threat of punishment for error is “nuclear” (i.e., disqualification of a plan or taxation of interest on bonds), customers and the Service both benefit from clear rules developed by consensus.

Customer Information and Reliance — Customers using voluntary compliance, whether through self-correction or through service-assisted procedures, must know in advance what their treatment is going to be and be

able to rely on the outcome. This includes information such as how long will the correction take and what will be the toll charge—the cost of the correction and the amount of any sanctions. Customers should feel comfortable that coming forward on a problem will not make them more likely to be selected for review on other matters. Tied into this is an important concept: The expectations of both the customers and the employees of TE/GE must be managed to reflect reality. For example, time frames that are established with respect to compliance must be realistic. Arrangements should be binding upon both the customers and the Service.

### Carrot and Stick Approach

The Carrot — Customers should be encouraged to correct any problems they discover on their own by a regime of no or substantially reduced penalties provided that some sort of correction can be obtained. (No penalties would be particularly appropriate where there is a good faith effort to comply on a timely basis followed by a program of self-review. In addition, given the unique intra-governmental relationship between the federal government and states, local governments, and Tribal governments, waiver of penalties should also be considered for self-correction by such governmental units.) Similarly, customers should be encouraged to establish programs involving good faith compliance efforts or reviews or similar non-Service related audits of their programs to make sure they are in compliance.

The Stick — The need for an active audit enforcement program, separate from the voluntary corrections program, cannot be overemphasized. TE/GE should have an active enforcement program, focusing on material issues and reckless non-compliers. Reckless or intentional non-compliers should be made to pay the cost of their noncompliance, both to encourage voluntary compliance and corrections, and so that voluntary compliers do not end up paying a higher cost than non-compliers.

Good Faith Compliance — “Good faith” compliance should be encouraged. In many instances (and across all segments of TE/GE) there is significant lag time between the enactment of laws and the issuance of guidance. The faithful compliers in EP, EO, TEB, FSLG and ITG will make efforts to operate in compliance with the law in the absence of bright-line guidance. In such instances, TE/GE should emphasize the operational effective date and good faith compliance. This can take the form of “snap-on” model amendments in EP and other suggested forms of good faith compliance, such as encouraging customers to adopt procedures designed to significantly increase the probability of compliance (such as the good faith compliance procedures relating to single family housing bonds).

Classify Degrees of Noncompliance – Sanctions for problems discovered on audit should be established taking into account the nature, extent, and severity of the violation. For example, for EO, EP, and TEB, distinctions must be made between minor defects and problems that go more directly to the heart of the reason for the tax-exempt status of the organization, the plan, or the bonds. The compliance program must try to classify problems in a way that distinguishes among three different types of noncompliance:

- “Intentional Non-Compliers” – persons who are purposefully misusing the system to accomplish goals that are not consistent with the reasons for the tax-exempt status
- “Malfeasing Non-Compliers” – persons who are not meeting the requirements because they simply don’t make an effort to develop what needs to be done to comply
- “Unintentional Non-Compliers” – persons who act in good faith, but don’t comply in full either because they do not understand the requirements or due to inadvertence

“The Punishment Must Fit the Crime” – Sanctions for problems discovered on audit should be established taking into account the nature, extent, and severity of the violation. Distinctions must be made between minor defects and problems that go more directly to the heart of the reason for the tax exemption. In addition, just as TE/GE experiences resource limitations, the Service must recognize that its customers may similarly experience resource limitations, which may be taken into account in determining appropriate corrections and sanctions.

One particular problem in the TEB area is the lack of correspondence between the “full taxpayer exposure” correction applied in many areas and any benefit that might have been received by the customer from noncompliance. Although the Service must be careful to do all it can to encourage compliance, programs that impose substantial penalties for relatively minor infractions will be unsuccessful. For example, there is a limit to what an issuer is willing to pay a tax lawyer to ensure that its bond issue continues to meet every single requirement over the often quite extended life of the bond issue, particularly in the light of the complexity of the rules and a disbelief that the full penalty will every really be enforced.

Separate Audits from Voluntary Corrections – Care must be taken to distinguish between audits and “Service-assisted” compliance programs. Audits carry rights and procedures and structural detritus.

Fix the Future – Corrections should not just fix the past problem but should also facilitate changes that can prevent the problem from recurring. One possible approach toward this goal is to encourage sponsors to set up practices and procedures to make sure plans operate in the right way. We note in the EP arena that the large number of plan constituents (i.e., the participants in the plan)

have their own interests that are consistent with many of the Service's concerns. Thus the participants may help drive a regular review of the status of the plan, resulting in the discovery of noncompliance matters by the plan sponsor. To some extent this is also true with respect to employee taxes and some similar issues that arise in the FSLG and ITG field.

By contrast, for exempt organizations and tax-exempt bonds, there may often be no external driving forces that encourage customers to comply with the tax law. In these situations, we encourage the Service to develop programs that provide an incentive to the customers to comply. An example of a type of program that might work can be seen in good faith compliance rules contained in the regulations relating to single-family bonds. (Temp. Reg. §6a.103A-2(c).) Another possibility would be to shift the burden of proof if a customer establishes and uses a self-audit type program.

### **III. Status of Various Divisions**

The following divisions have been organized based upon our perceived view of the status of the development of a voluntary compliance/self-correction program.

#### **A. Employee Plans**

##### ***Overview and Current Challenges***

The Employee Plans group has progressed the furthest with voluntary compliance programs. TE/GE has worked for a number of years to develop voluntary compliance programs for tax-qualified plans. We commend TE/GE, the IRS generally and Treasury for the excellent development thus far. We believe this program has a number of successful attributes. Some of these are reflected in recommendations for other areas. We also believe that the program for EP can be improved, and have specific suggestions for the existing EP program. Finally we note that Congress has also endorsed the success of the EP voluntary compliance, and in the current Congress legislation has been introduced in the House (H.R. 3762) specifically requesting various changes, including an extension of the two-year corrections period for "significant" failures.

##### ***Status of Voluntary Correction Programs***

In 1998, EP consolidated several separate EP correction programs and created the Office of Voluntary Compliance with the goal of establishing consistency, end-to-end accountability, and uniformity in the EP compliance area. The consolidated programs are described in revenue procedures which have been updated regularly, Rev. Proc 98-22, Rev. Proc. 2000-16, Rev. Proc

2001-17, and a further Revenue Procedure expected to be published in the summer of 2002.

The consolidated Employee Plans Compliance Resolution System (EPCRS) encompasses the following major categories of correction procedures:

- Self-correction (SCP), independent of the Service and without fee or sanction
- Voluntary Correction (VCP), requires Service review and a limited fee:
  - Voluntary Correction of Operational Failures (VCO)
  - Standardized Correction of Operational Failures (VCS)
  - Voluntary Correction of Tax-Sheltered Annuities (VCT)
  - Anonymous Submissions
  - Voluntary Correction of Group Failures (VCGroup)
  - Voluntary Correction of SEP Failures (VCSEP)
- Audit Closing Agreements (Audit CAP), an involuntary corrections process initiated by the Service and involving a sanction

In recent years TE/GE has made great strides in improving and expanding the corrections program: consolidating three different programs into a single program in 1998, publishing some general corrections principles underlying its guidance, and expanding the scope of possible corrections.

### ***Opportunities***

Below are some modifications that we believe will increase the opportunities for additional voluntary compliance by plans that might otherwise fail to make corrections. In some cases these recommendations increase the opportunities for self-correction, with the expectation that persons not currently taking advantage of corrections programs might take advantage of additional opportunities to self-correct.

#### **Unlimited Period for Retroactive Corrections**

**1. Solicit customer input, develop concepts and publish guidance expanding the corrections period to permit significant corrections to be made retroactively without a time limit, under a set of defined conditions, such as the following:**

- The decision to correct must be made within a limited period of time after the problem is discovered, such as 12-18 months
- The correction must be fully executed within a limited period of time after the decision to correct has been made, such as 24-36 months.
- The correction method must be fully within an approved method.
- The correction must be reported to the Service.

- The Service should have a defined period of time after receiving the corrections report within which to determine whether to review the correction, and a second defined period to complete an audit and require a further correction if appropriate.
- If the Service opts not to review the correction, it will be deemed to be approved.
- If the Service reviews the correction and requires further correction:
  - The plan will not be disqualified
  - Any penalties should be assessed only to address “bad faith” or clearly deficient corrections, and should be substantially lower than penalties assessed on a Service-initiated audit.
- If the plan sponsor makes the correction, the correction is not reported to the Service, and the correction is subsequently discovered on audit, the Service may assess substantial penalties.

No penalties or fees should apply if the Service requires further correction of a reported correction.

The current program allows self-correction of some errors within two tax years of the error. For corrections going back further, the Service must be involved if the correction is “significant.” Recent Congressional legislation (H.R. 3762) proposes that this corrections period be extended. We concur with an expanded corrections period, and propose that the corrections period be expanded even in the absence of Congressional legislation.

Establishing a time limit for corrections based on when the error occurred discourages many plan administrators from undertaking correction of past problems. We recognize that some time restrictions are necessary in order to encourage plan administrators to move quickly in both identifying the scope of the problem and implementing a correction. We also recognize that for large plans the data-gathering process and the special procedures necessary to implement a correction can be very time consuming and costly. For these reasons we recommend that time limits be focused on discovery of an error and implementation of the correction, rather than when the error occurred. Since self-correction of this type would be an alternative to Service-assisted correction, we recommend that the scope of the exception be limited, such as being limited solely to correction methods clearly within the scope of the written guidance. Reporting the correction to the Service and giving the Service opportunity to require further corrective methods may discourage plan administrators from using this alternative, but we also believe that those measures will both prevent abuse of this correction alternative and will increase Service awareness of the types of problems requiring correction.

### Missing Data

**2. Solicit customer input, develop concepts and publish guidance for using the best available data for corrections.** It is not unusual for plan administrators to be unable to find or recreate missing data relevant for a correction. This creates a practical problem in correcting older errors. For example, where a defined benefit plan uses ten-year average compensation, describe methods for filling in gaps in that ten-year period.

### Form Deficiencies

**3. Solicit customer input, develop concepts and publish guidance permitting self-correction of form deficiencies in limited situations, not just scrivener errors, where over a specified period of time the plan has been consistently administered in a fashion contrary to the plan language and the vast majority of the disclosures to employees support the plan's administration.** Currently, the only correction method available for form deficiencies is VCP process, the cost of which may far exceed the benefit being addressed. We recommend that the Service expand the correction methods available to permit limited corrections of plan documents through plan amendments with retroactive effect. For example, it is not unusual for a plan sponsor to check the wrong box on a prototype plan adoption agreement, or fail to check a relevant box, but the sponsor's intent, the plan's operation and communications to employees are all consistent with a design which differs from the text of the plan document. We recommend that to reduce the cost of correction, certain corrections be permitted as self-corrections.

### Non-Standard Correction Methods

**4. Solicit customer input, develop concepts and publish additional guidance on how to deal with operational defects that don't violate a particular code section.** Current guidance does not cover a number of problem areas. For example, how should plan sponsor correct a misallocation of matching contributions which resulted from using improper compensation that doesn't result in any 415, 402(g), 401(a)(17) or 401(m) violations?

### Additional Guidance on Reporting Income from Corrections.

**5. Solicit customer input, develop concepts and publish guidance on reporting income from the correction of operational defects.** For example, where amounts have already been distributed (including rolled over to an IRA), how does the plan sponsor amend previous Forms 1099-R to indicate that the amount is not eligible for rollover? And how does the accepting plan report the distribution back of the amount ineligible for rollover?

### Corrections During Determination Letter Process

**6. Solicit customer input, develop concepts and publish guidance providing for the correction of deficiencies discovered through the determination letter process.** The DL process is voluntary; and filers should not be penalized with an audit-style sanction when they are proactively working to ensure their plan operates correctly.

We believe that no sanctions should apply when corrections are required as a result the determination letter process. The determination letter process is voluntary, and plan sponsors should not be dissuaded from seeking determination letters out of fear that the Service might impose sanctions in connection with an issue surfaced during the determination letter process.

### Encourage Self-audit Programs (SAP)

**7. Solicit customer input, develop concepts and publish guidance supporting self-audit programs.** Build a structure under which sanctions could be reduced or eliminated where a plan sponsor can show a history of self-initiated, good-faith compliance audits. Issue guidelines for what constitutes a self-audit program.

We recommend that plan sponsors be encouraged to conduct periodic self audits of their compliance efforts by reducing sanctions for plans with evidence of routine compliance audits. If a plan sponsor has been audited and showed evidence of a formal process of periodic self-audits, then any deficiencies discovered during the IRS audit should not be subject to any penalties.

## **B. Tax-Exempt Bonds**

### ***Overview and Current Challenges***

In the tax-exempt bond area, a directed audit program and a self-correction program are relatively recent matters with histories shorter than employee plans. There are a small number of audit initiatives proceeding, and most self-correction procedures have been developed in the context of requests from the tax-exempt bond industry. Many of these are not expressly stated in the form of "self correction programs," but are instead seen as guidance relating to allocations or changes in use. However, we believe that many important elements of a successful self-correction program have been adopted by TEB, and TEB should strive to continue to develop a more mature program using these beginnings.

In addition, we note that TEB has made significant strides in the outreach area, including development of its website, preparation of some pamphlets, and



substantial presentations at meeting of industry and client organizations (such as NABL, ABA, and GFOA). We are pleased to see such developments and encourage TEB to continue outreach, especially at the level of direct contact with the issuer community.

There are at least three significant challenges that face TEB as it continues to develop its self-correction programs.

One challenge facing TEB is determining the appropriate penalties for noncompliance in the context of a voluntary disclosure and correction of noncompliance. As written, the sole penalty imposed by the statute for noncompliance is taxability of interest on the debt. Although there have been very few cases that have resulted in taxing bondholders, many audits are resolved with the Service seeking a closing agreement payment equal to the full taxpayer exposure on the debt, which can be a very large number. Because they fear exposure to payment of such a large penalty, issuers are less likely to come forward voluntarily when they discover problems with their issues and are more willing to take an audit risk.

A second TEB-specific challenge is the fact that experts are only involved with the bonds at the time the bonds are issued and ongoing review of programs is rare. Bond programs rarely are established with any kind of on-going compliance or overview, apart from calculation of rebate. In addition, there is a high rate of turnover in the employees of issuers, so often those who have been involved in the bond issue are not around during the entire 20 or so year term of the issue. Institutional knowledge relating to the bond issue gets lost and there is no incentive to make sure the bond program is working. In addition, there is no obvious constituency that has an incentive to make sure that the bond issuers continue to comply with the tax laws after the bonds are issued (as there is with the beneficiaries of employee plans).

A third challenge is the complexity of the rules and, even more important, the lack of clear guidance in many areas. To date, the TEB clientele are not getting sufficient feedback from the audit process. The industry is not learning what types of problems commonly recur and therefore tax counsel are often unable to help guide issuers and issuers are often unaware of arrangements that may give rise to compliance problems. We understand that TEB audits have identified a number of common problems: improper application of depreciation under Section 168(g), frequent violation of the capital expenditure limit for exempt small issues, difficulty in identifying what is "manufacturing" for purposes of the exempt small issue rules, rebate underpayments, and yield restriction compliance problems. The fact that these are common problems should be made more widely known (by discussion at industry meetings and by posting on the IRS website).

### ***Status of Voluntary Correction Programs***

Prior to 1986, the status of tax-exempt debt was generally determined at the time the bonds were issued and was largely based upon reasonable expectations at the time the bonds were issued. Accordingly, most compliance was focused on the time the bonds were issued, with little oversight during the term of the bond issue. However, the 1986 Tax Reform Act made it clear that post-issuance acts can cause bonds to become taxable. In response to the focus on post-issuance compliance, TEB (and its predecessors) have worked for more than 10 years on developing various rules relating to self correction. Recently, a notice has been released suggesting a broader self-correction program. In specific, the Service has been involved in the following, which might be viewed as the “TEB self correction program”:

- Rev. Proc. 88-10, relating to Forms 8038. This procedure relates to a minor noncompliance issue, the failure to file an appropriate form with the IRS, and provides an easily understood and executed correction procedure. This program was developed to deal with the substantial number of private letter ruling requests that the Service was receiving relating to the discovery by counsel that the Form 8038 had not been filed in a timely fashion. Counsel were understandably quite worried about these discoveries, as, under the statute, the penalty for failure to file the form in a timely fashion is draconian—taxability of the bonds. The simple corrective procedure set forth in the Revenue Procedure is properly viewed by the bond counsel community as very effective and issuer friendly. To the extent that a similar program can be developed for other “footfault” type violations, the Service is highly encouraged to follow this model.
- Rev. Proc. 90-11, relating to late rebate and interest and penalties. Although this procedure provides for a means of implementing rules established in the regulations, it also functions as a type of self-correction program. If an issuer discovers that it has inadvertently paid rebate late to the IRS or has improperly calculated and paid previously determined rebate, the revenue procedure states how the issuer corrects the problem. Again, this revenue procedure is viewed as noncontroversial and successful.
- Rev. Proc. 96-41, relating to yield burning. This revenue procedure resulted in a storm of criticism of the Service by the bond community. It established a closing agreement procedure for resolving potential problems with yield burning. The problem with the procedure, from the industry’s point of view, is that it was an attempt by the Service to apply retroactive standards in an area where bond counsel had already recognized a problem and had

attempted to establish procedures to prevent yield burning *without consulting with the industry as to the procedures it had already used*. As a result, the standard set forth in the procedure didn't comport with what practitioners had been doing to try to prevent the problem and the standard was unexpected. One lesson to be learned from Revenue Procedure 96-41 is that it is better to develop methods that correct prior problems in consultation with the industry. In most cases, where the Service determines that new standards must be developed and applied, we believe that it is best to apply those procedures on a prospective basis.

- Rev. Proc. 97-15, relating to change in use. This procedure goes hand in hand with regulations § 1.141-12 and provides for actions that an issuer can take to prevent taxability when deliberate action is taken and the alternatives provided in the regulations are not available. It requires that the corrective action be taken within 90 days (generally) after disqualifying action. For most bonds issued after §1.141-12 were issued, the bond issues were designed to fit into the new regulations. Accordingly, this revenue procedure deals with a fairly limited number of cases. Many issuers will consult with bond counsel when doing deliberate actions that would otherwise cause the interest on the bonds to be taxable, and those issuers can take advantage of Rev. Proc. 97-15. However, the procedure is limited in that the time period for taking corrective action is quite limited and issuers may take actions without consulting with counsel. Accordingly, the Service should consider expanding the cases and the time period for correction covered by Rev. Proc. 97-15.
- Reg. §1.141-12, relating to change in use. This provision of the regulations gives issuers a number of actions they can take to prevent post-closing changes in use of the proceeds of their bonds from causing the interest on the bonds to be taxable. These regulations set forth clear guidelines for issuers to follow, and as a result have been fairly well received and successful in the industry.
- Reg. §1.141-6, allowing for reallocation of bond proceeds within 18 months of an expenditure. These regulations allow issuers a limited time period for correcting inadvertent initial use of bond proceeds if the issuer has other qualifying expenditures that it could have spent bond proceeds on. Although not strictly a self-correction program, this provision of the regulations is consistent with the practice developed by the bond industry as a whole to deal with inadvertent expenditures and is fairly well received. If the regulations were subject to criticism, it would be that the ability to

reallocate bond proceeds to qualifying expenditures can only happen during a very limited time period.

- Notice 2001-60, establishing a voluntary closing agreement program. This notice establishes a more general program aimed at dealing with issuer discovered problems that do not fit into any of the programs described above. It does not apply if the issue is under audit or is at issue in any court or IRS proceeding and does not if the failure of the issuers was due to willful neglect. Actions consistent with the notice must be undertaken promptly upon discovery of the violation. In addition, any closing agreement entered into under the notice must provide for a showing that the United States will sustain no disadvantage through consummation of the agreement. It also allows issuers to approach the Service on anonymous basis to undertake discussions about possible settlement.
- Announcement 2001-101, providing relief for issuers of tax-exempt bonds affected by last year's terrorist attack. Although not specifically a voluntary compliance or self-correction program, the Announcement does include a provision allowing relief under appropriate circumstances for affected issuers that were unable to comply with the tax-exempt bond rules relating to their bonds. Such relief is only granted on an issue-by-issue basis, and issuers must contact the TEB OPR for requesting relief. As applied, this notice has effectively been used as an alternative to the private letter ruling process.

Notice 2001-60 is a good step toward the development of a more general voluntary compliance program, indicating willingness on the part of TEB to work with issuers and the municipal bond industry to develop a better self-correction program. In particular, the ability of an issuer to approach the Service on an anonymous basis gives the issuers the ability to determine in a fairly risk-free manner what the potential costs of correction might be. However, the program needs more development. In particular, issuers need to have the ability in many cases to determine for themselves in advance what the potential penalties might be. This will encourage more issuers to come forward and correct self-discovered problems rather than run the audit risk (where they may think that the penalties would not be significantly different in any case from coming forward voluntarily today). In addition, the customers do not have any certainty of consistent treatment under the program, since it is designed to be operated on a relatively ad hoc basis, although we understand from discussions with TEB personnel that all closing agreements under 2001-60 are ultimately reviewed by the same persons with the intent of establishing equitable treatment among customers. Finally, we believe that more must be done to encourage issuers to periodically review their bond programs for compliance.

We note that Notice 2001-60 does seek further input from the tax-exempt bond community to help develop the program further. We also note that TEB personnel have met with representatives of the National Association of Bond Lawyers and the Tax-exempt Financing subcommittee of the Tax Committee of the American Bar Association on numerous occasions to discuss the scope of voluntary compliance and the range of appropriate penalties. NABL has also put forth a proposal relating to the development of an alternative penalty regime that may be pertinent to the development of a more comprehensive program. In addition, TEB continues to work on a number of developments, including potential revisions to Rev. Proc. 88-10 and Rev. Proc. 90-11, draft revisions to update current IRM procedures that will, in part, expand and elaborate on Notice 2001-60, and a draft "easy-to-read" publication on Notice 2001-60. In short, we note that significant steps have been taken by the Service toward a voluntary compliance program in TEB; however, we also note that significant steps remain.

### ***Opportunities***

**1. Development of appropriate penalty or correction costs relating to voluntary correction.** As discussed above, one particular issue that needs to be addressed in developing a self-correction program is how to determine appropriate penalties for various violations in cases where the issuer voluntarily corrects noncompliance (with or without Service intervention). The development of an appropriate penalty scheme in the audit context has been under discussion in the municipal bond industry, and at least one or two formal proposals have been made to the Service. We believe that it is appropriate for TEB, working together with Appeals and the Chief Counsel's office, to encourage further discussion on this issue, but in addition to consider specifically establishing an alternative and lesser penalty scheme to handle voluntary self-correction. Such discussion should involve various industry groups, including the GFOA, NAST, NABL, and ABA. We note in advance that in the TEB customer base there is no consensus on any appropriate level for penalties.

The use of a reduced penalty scheme or reduced cost of correction in conjunction with a voluntary correction and disclosure program will help to encourage issuers to find possible noncompliance matters and correct them. Tied into the development of a reduced penalty scheme for voluntary correction, it may be appropriate to develop a program that promises additional sanctions to issuers that do discover problems but fail to report them or, even worse, fail to correct them.

**2. Encourage development of issuer-based self audit programs.** As discussed above, TEB (perhaps like EO) has particular problems with continuing compliance. The rules for compliance are fairly complicated, professionals are generally only involved at the time the bonds are issued (with the limited exception of those issues that are and continue to be subject to rebate

calculation, where there is limited review of arbitrage by professionals), and frequently the employees of the municipal entities that issued the bonds (or of the conduit borrower) who were around at the time the bonds were issued and who presumably had some exposure to the rules at that time leave well before the compliance period is over—i.e., before the bonds are retired. The Service should give serious consideration to encouraging a self-audit program relating to TEB. Such a program could be done on a voluntary, regular basis. The Service could establish incentives for the issuer who chooses to do such an audit (e.g., at the time the projects financed with the bonds were completed and perhaps on an every five year basis after that). Appropriate incentives might include substantially reduced penalties if problems were discovered on audit or a significant shifting of the burden of proof relating to noncompliance. Another possible approach would be to extend the deadlines for correction described in Regulations §§1.141-12 and 1.141-6 or to give more strength to the reasonable expectations of issuer as redetermined from time to time as a result of the periodic audit. Again, we encourage the Service to work with industry groups to considered development of such a program.

**3. Continue and expand outreach program relating to common problems.** As the Service uses both its audit program and expands the voluntary correction program, TEB should expand its outreach program to include further information as to the types of errors that it finds on a regular basis. We are aware that section 6103 imposes substantial limitations upon the ability to make information derived from audits available to the general public. However, we believe that some generalized information could be released, perhaps in a digest form or in the form of collected statistical information, and development of such a program should be considered to the extent consistent with taxpayer confidentiality. In addition, the Service should consider whether these items or others that show up regularly should give rise to additional regulations (where the law may not be clear), notices, IRS publications, or educational materials (where the law may be clear—at least to the Service—but may need to be disseminated more thoroughly), and recycling into a self correction program (where the errors are common, but ought to be able to be discovered and corrected in some reasonable manner without Service intervention).

**4. Require that Form 8038-T be filed even if no rebate is due.** Current regulations require that Form 8038-T only be filed if rebate is due. This arrangement raises significant administrative problems—i.e., if no 8038-T is filed, is it a result of no rebate due or a failure to review the rebate status. The form should be modified to allow a simplified statement if no rebate is due to reduce compliance costs in the event that an issuer is able to determine that no rebate is due because of constant investment in nonpurpose investments with yields below bond yield. Requiring such a filing would help to insure some level of periodic review by issuers of their bond issues.

**5. Provide information to issuers at time Form 8038 is filed.** We understand that TEB is developing informational releases relating to on-going compliance issues faced by bond issuers for various types of bond issues (e.g., governmental bonds, 501(c)(3) bonds, and other private activity bonds). We highly encourage the development and use of such informational releases. We believe that voluntary compliance and review can be especially encouraged by the dissemination of such pamphlets to issuers at the time the bonds are issued. We suggest that the appropriate release be returned to each issuer in response to the receipt of each 8038, 8038-G, 8038-GC, and 8038-T. This will help to remind the issuers of the compliance requirements relating to their bonds. To simplify this process, Forms 8038 and 8038-T may be modified to provide a checkbox identifying the type of issue in a manner that ties into the types of informational releases available. (Such identification probably would not be needed for Forms 8038-G and 8038GC.)

## **C. Exempt Organizations**

### ***Overview and Current Challenges***

A significant challenge facing EO customer support efforts and related compliance is the tremendous variety among tax-exempt entities. Tax-exempt market segments differ widely in their business activities, with activities ranging from the delivery of health care to the operation of social clubs for the benefit of members, from higher education to business leagues for the benefit of industry. While there are some compliance commonalities across market segments, each market segment also demands a particular area of taxpayer education and its own unique, and often very complex, compliance requirements.

The size and scope of tax-exempt organizations also varies substantially. The IRS recognized approximately 1.3 million tax-exempt organizations. It is estimated that approximately 40 % of these tax-exempt organizations have annual operations of less than \$25,000 per year, and approximately 60% of these tax-exempt organizations have annual operations over \$25,000 per year. The Internal Revenue Service does not have sufficient internal resources to be “all things to all organizations.” There is no “one size fits all” solution to educating tax-exempt customers and executing a comprehensive tax-exempt entity audit program to ensure compliance.

Churches, certain religious organizations and other tax-exempt organizations with annual operations under \$25,000 are relieved from an annual information return filing with the IRS. As a result, only 52% of recognized tax-exempt organizations file with the Service on annual basis. These demographics create a challenge for EO in terms of communicating with all tax-exempt organizations from both a taxpayer education perspective and from the perspective of ensuring taxpayer compliance.

An additional and significant challenge facing EO is its present determinations program. The number of new organizations seeking tax-exempt determination is increasing each year. The IRS expects to process close to 90,000 determination requests during its FY2002, up from 75,000 just four years ago in FY1999. The current IRS determinations process consumes an inordinate amount of EO resources. As a result, resources for education and audit activities for the benefit of the EO customer community are reduced.

Examination activity in the Exempt Organizations taxpayer community has been fairly limited in recent years:

- CEP audits (“Comprehensive Examination Program”) of hospitals and universities. These examinations have included the exempt organizations and their service partners.
- Initial 4958 exams (relating to taxes on excess benefit transactions).
- Some examinations of exempt organizations relating to issues other than exemption: e.g., 403(b) issues.
- Few audits of other (c)(3)s, (c)(4)s, (c)(5)s, and (c)(6)s.

### ***Status of Voluntary Corrections Programs***

Existing self-compliance tools and programs for the Exempt Organization community are summarized below:

- A walk-in closing agreement program; however, the closing agreement activity has been relatively ad hoc.
- Audit guidelines have been developed for hospitals and universities and made available to the public.
- An IRS developed self-audit check-list for intermediate sanctions self-assessment and self-compliance.
- 403(b) voluntary compliance program is available to Exempt Organizations that often sponsor such retirement programs for their employees.
- VCP related to foreign national payments available to Exempt Organizations that make payments to foreign nationals.
- Bond compliance programs applicable to many exempt organizations that issue tax-exempt debt.

### ***Opportunities***

The following ideas are presented as opportunities for EO to enable greater voluntary compliance with modifications to existing practice and procedure:

- 1. Assist taxpayers in better understanding the life cycle of their exempt organization** and identify the appropriate points of intersection between



the organization and the IRS for improved compliance with federal tax laws. This idea is further discussed by the Life Cycle Subcommittee.

**2. Undertake an effort to create efficiencies and improvements in the determinations process** in order to better deploy IRS resources to taxpayer education, outreach and compliance.

**3. Provide a reasonable compliance framework in which an exempt organization can address a change in purpose from a compliance perspective:**

Change in purpose, but still a Section 501(c)(3) organization  
Change in purpose, but still exempt under another provision  
Change in purpose, and now no longer exempt

**4. Develop some sort of standardized settlement agreement for unique compliance issues.** It would be important to provide uniform treatment: and horizontal equity among customers.

**5. Develop a compliance framework in which small, dormant organizations that have previously quit filing Forms 990 but that have recently expanded in financial volume and programmatic scope can be reintroduced to annual filings, as appropriate, in a non-punitive manner.**

**6. Develop a compliance framework in which exempt organizations understand how to address changes in their public support status without penalty.** Such a framework would seem to be especially appropriate (1) if change in public support goes below 33% and (2) if change in public support goes below 10% two years in a row.

**7. Consider extension of VCP for the tax treatment of payments to foreign nationals (compensatory payments, scholarships),** a significant compliance area for universities and an area in which penalties are severe.

**8. Provide private foundations with a framework within which to correct voluntarily procedural mistakes under Section 4945 without fear of financial penalty.** Examples of procedural mistakes include the following: taxpayer inadvertently awards a study or travel grant before securing IRS approval on grant procedures; or taxpayer inadvertently forgets to attach a report to Form 990-PF for taxable expenditures when filing.

The committee recognizes that constituent input will be very important to the process of developing a customer friendly compliance and education program for exempt organizations. The committee would encourage industry groups such as the ABA Tax Section of the EO Committee, NACUBO, and

others to provide market specific comments and suggestions for further IRS consideration.

## **D. Federal State and Local Governments (FSLG)**

### ***Overview and Current Challenges***

FSLG serves approximately 87,000 customers with 99% of the total customer base representing local government units (such as city municipalities, county agencies, public school districts). Customers also include the federal government, state governments and agencies, and “quasi-governmental” entities (such as transit authorities, port authorities, and the postal service).

In general, the scope of FSLG’s compliance efforts relates to employment tax and information reporting matters. FSLG audits Forms 941 (Employer’s Quarterly Tax Return); worker classification issues, fringe benefits, FICA, Section 218 of the Social Security Act, and appropriate filing of Forms 1099 with respect to vendors payments and other payments. Existing FSLG audit activity is focused on employment tax and information reporting requirements.

FSLG is charged with supporting Exempt Organizations and Employee Plans in terms of employment tax examination assistance on large cases and joint outreach to government entities. There is also a need to promote FSLG to the other IRS operating divisions and functions. At the present time, FSLG’s internal and external customers, partners, and stakeholders have limited information about the mission and objectives of the division.

The FSLG customer base also includes certain public customers such as hospitals and universities that could also be considered EO customers and EP customers, as well. Customers and customer relationships will need to be more clearly defined within the context of FSLG and overall IRS outreach and compliance efforts. FSLG will need to coordinate closely with other divisions of TEGE with respect to its outreach and compliance activities.

FSLG is currently drafting a joint memorandum with Exempt Organization Examination to clarify jurisdictional and coordination issues to address common customers (public employers) that have historically been served by the Exempt Organization Examination Division prior to the existence of FSLG. A joint memorandum with Employee Plans (EP) also needs to be drafted to assist in the coordination of outreach efforts by EP to public employers with pension plans (Section 457 and 403(b)) as well as potential employment tax issues (FICA) generated by the treatment of contributions to the plans.

FSLG’s partnership with the Social Security Administration (SSA) (State and Local Coverage) resulted in a recently signed Memorandum of

Understanding (MOU) to support joint educational efforts to state and local employers as well as sharing information to ensure accurate wage reporting and compliance with federal law.

### ***Status of Voluntary Correction Programs***

FSLG views itself as an education and compliance oriented function. It is currently in the process of distributing various forms of information to taxpayers. Several products and services are under development (i.e. brochures, bookmarks, newsletter, web site, outreach presentations, VCAP, IRP, workshops) but there is currently no comprehensive marketing strategy to promote these products and services.

FSLG, SSA and the National Conference of State Social Security Administrators are very close to completing a comprehensive revision of the third edition of the Fed/State Reference Guide, Publication 963. This is the first revision in four years and addresses new legislation over the past four years and the modernized IRS that includes the FSLG division that did not exist in 1997.

Educational products and other forms of guidance have been issued covering Respite Health Care, Information Return Reporting Rehired Annuitants, Employment Status of Appointed and Elected Officials, Accountable Plans, Worker Classification and other issues.

Current FSLG publications are as follows:

- Federal-State Reference Guide (Social Security Coverage and FICA Reporting by State and Local Government Employers) – Publication 963 (Rev. 10-97 but currently being revised). Provides State and local government employers a comprehensive reference source for Social Security and Medicare coverage, withholding and reporting issues.
- Federal, State, and Local Governments – Publication 3809 (Rev. 07-2001). This two-page pamphlet provides an overview of the office of Federal, State and Local Governments with regional and central office phone numbers.
- Federal, State and Local Governments – Publication 3810 (Rev. 07-2001). This is an informational bookmark used for public relations.

FSLG plans to coordinate its tax outreach and audit efforts through the employment tax advisory committee, which includes other divisions of the IRS such as LMSB (Large and Mid-size Businesses) and SBSE (Small Business and Self Employed Individuals). One objective of this advisory committee will be

equitable treatment of taxpayers on similar issues across varying market segments. FSLG views its mission as helping its customers understand and comply with the law through education and limited use of compliance checks and examinations to verify compliance and address willful or chronic noncompliance.

Closing agreements are available to taxpayers in correcting a FSLG compliance matter, but currently closing agreements are administered on an ad hoc basis. In addition, a Worker Classification Settlement Program is available, but only for taxpayers currently under audit. The intent of this program is to push settlement authority for worker misclassification issues down from the appeals level to the audit level.

### ***Opportunities***

**1. Clarify FSLG interface with its customer base.** As mentioned earlier, many FSLG customers will also be EO and EP and TEB customers. FSLG, as all of TE/GE must determine how to best interface with its customer base. Customer portals into the TE/GE organization should be considered, so customers don't have to shop around for the assistance they need. The portals would provide appropriate redirection and advice. FSLG in concert with TE/GE should develop a program in which the Service takes responsibility for customer information requests and for getting them to the right resource within TE/GE.

**2. Explore the concept of self-correction/compliance programs.** FSLG views its mission as educating and encouraging voluntary corrective action from taxpayers. In this regard, we encourage FSLG to pursue its idea of compliance checks or reviews in certain areas, followed by correction without penalty, and then a follow-up in a couple of years. If at the time of the follow-up, FSLG finds continuing problems, penalties would be considered based on the applicable facts and circumstances of each situation.

A self-correction program would enable taxpayers to achieve voluntary compliance by conducting a review of their employment issues and correcting compliance issues discovered. Compliance issues, corrective action and notification requirements should be clearly outlined in an appropriate Revenue Procedure. Corrective action issues could be corrected with Service assistance, limiting tax liability to prospective treatment. A voluntary closing agreement could be used when a government entity contacts the Service to report a self-correction issue.

In implementing a self-correction program, the following steps should be followed:

- Conduct research on all available self-correction/closing agreement programs

- Secure feedback from stakeholders on self-correction issues and closing agreements
- Determine how the program will be implemented (e.g. roles of specialist, managers, Operations Program Manager and Director)
- Develop a marketing plan (e.g. official notice, web page, letters to taxpayers)
- Develop protocol for signatures and approval process
- Develop customized closing agreements and procedures for different market segments (federal, state, and local)
- Develop Internal Revenue Manual procedures
- Develop method for monitoring closing agreements
- Develop and provide training for users

**3. Leverage participation in the Service's Employment Tax Advisory Committee force to further develop closing agreement opportunities.**

FSLG is well positioned to develop a more comprehensive program for compliance and outreach in cooperation with the Employment Tax Advisory Committee. In particular, by working with the Employment Tax Advisory Committee within the Service, FSLG should further explore, develop and formalize closing agreement opportunities that can be made available on specific issues and in an equitable manner to all taxpayers.

IRC Section 7121 and the regulations there under authorize the Commissioner to enter into written closing agreements with any person related to the internal revenue tax liability of such person. This authority is delegated to the Commissioner of TE/GE with respect to matters within her jurisdiction.

A closing agreement, as authorized by IRC 7121, can be a useful tool to resolve disputes between the Service and taxpayers. Closing agreements fit well into the Service's Balanced Measures approach to promoting compliance as well as customer service. Compliance is served while conserving the Service's scarce resources and all parties gain something from a properly executed closing agreement. The taxpayer obtains both certainty that the matter is concluded and guidance on how to comply in the future. The Service resolves a compliance problem that otherwise would consume time and resources and obtains a commitment to future compliance.

Closing agreements are currently in existence in several areas of the Service. These programs indicate their potential usefulness in the FSLG. FSLG should focus on programs in the area of, self-correction without assistance in those areas that relate to well-established issues, voluntary closing agreements with the Service's assistance for more complicated issues, and audit closing agreements where the audit process has been completed. The closing agreements would include agreement on tax liability and prospective treatment on compliance issues.

**4. Develop a comprehensive marketing plan for FSLG.** FSLG has recently drafted a comprehensive marketing strategy for internal and external customers, partners and stakeholders. However, there is currently no marketing plan in place for FSLG. FSLG should continue to develop a comprehensive marketing plan to promote its products, services and compliance programs both within the IRS and for external customers, partners and stakeholders.

As a first step, we recommend FSLG dedicate resources to further develop the FSLG web page. The FSLG customers should benefit from a strong web presence since the majority of state and local government entities have Internet access and readily utilize the Web as a research and informational tool. An enhanced FSLG web site will greatly assist FSLG as they identify their customer base, determine their informational needs and develop applicable educational materials. The web should also be used to provide customers with forms, guidance, hot topics and links to both the federal and state/local levels.

Key action items for development of the FSLG marketing plan should include:

- Identify internal staffing and external consultants
- Identify market segments of internal and external customers, partners and stakeholders to market FSLG products and services
- Identify existing marketing products/tools and services that can be used
  - Newsletter
  - FSLG Forms/Publications/Information Brochures
  - FSLG Technical Assistance Procedures
  - FAQs
  - Letter Rulings
  - FSLG Calendar of Events
  - FSLG Outreach Documents
  - Current/Emerging Issues
- Secure feedback from stakeholders on proposed marketing materials
- Develop a comprehensive strategy to promote FSLG products and services

In addition, reference should be made to the Advisory Committee on Tax Exempt/Governmental Entities (ACT), Report from Education/Outreach Project for additional marketing recommendations.

## **E. Indian Tribal Governments (ITG)**

### ***Overview and Current Challenges***

There are over 560 federally recognized Indian tribal governments in the United States. The U.S. Constitution, various treaties, federal statutes, Supreme Court decisions and executive orders and policies all, taken together, establish the foundation for the unique relationship between the U.S. Government and the Tribes. Based upon similar filing characteristics and other factors, the IRS has divided this customer group into three market segments:

- Alaskan Native governments
- Tribal governments with Class III gaming, and
- Tribal governments without Class III gaming

In the past, there have been few and inconsistent interactions between Tribal Governments and the IRS. Agreements between the IRS and Tribal Governments have typically been individually negotiated agreements. With recent growth in Tribal economies and new areas of federal tax law arising for the Tribes, consultation, additional education and consistent interaction will be required to encourage compliance with federal tax laws.

The relatively new office of Indian Tribal Governments (ITG) at the Internal Revenue Service was established to help Indian tribes deal with their federal tax matters and to provide a single point of contact for assistance and service. The overall goal of this office is to use partnership opportunities with Indian tribal governments, tribal associations, and other federal agencies to respectfully and cooperatively meet the needs of both the Indian tribal governments and the federal government, and to simplify the tax administration process.

Some areas of compliance challenge for Tribal Governments include: tribal governments as employers, distributions to tribal members, establishment of governmental programs, trusts and businesses, employment tax, information return reporting, tip income reporting, trusts for minors, and gaming excise taxes.

### ***Status of Voluntary Correction Programs***

The Indian Tribal Governments office provides a single point of contact for assistance and service. Five field groups provide primary front-line service and are aligned to respect tribal affiliations wherever possible. These field groups consist of tribal government specialists who work in locations near the seats of tribal governments. The specialists can address issues and provide guidance unique to Indian country. Issues may relate to tribal governments as employers, distributions to tribal members, and the establishment of governmental programs, trusts and businesses.

Currently, ITG resources are directed to providing assistance, information and education to tribal governments. To date, voluntary correction programs, compliance reviews or closing agreement programs have not been addressed

due to the Service's high priority placed on establishing the ITG office and organizing the office functions.

The ITG Web page provides access to a significant amount of information related to regulations and rulings, helpful resources, current issues and an Indian Tribal Governments Tax Kit. A "Frequently Asked Questions" section is under development and should offer additional access to quick information to selected issues.

IRS Publication 3747 (6-2001), Introduction to Indian Tribal Governments, is an introductory brochure describing the new office of Indian Tribal Government at the IRS. The brochure discusses the education and customer service available from the ITG Division. Although not exhaustive, the Code sections, regulations and rulings listed below provide guidance regarding federal tax administration as it relates to tribal governments.

- IRC Section 7871, Indian tribal governments treated as States for certain purposes.
- IRC Section 7873 - Income derived by Indians from exercise of fishing rights.
- Revenue Procedure 2001-15 - A modified and supplemented listing of Indian tribal governments that are to be treated similarly to States.
- Revenue Ruling 68-38 - Payments made from funds... to unemployed and underemployed residents of an Indian reservation... are not wages.
- Revenue Ruling 67-284 - Principles applicable to the Federal income tax treatment of income paid to or on behalf of enrolled members of Indian tribes.
- Revenue Ruling 59-354 - Amounts paid to members of Indian tribal councils for services performed by them as council members do not constitute wages.
- IRM 4231 Section 533 - Tax audit guidelines re: Indian fishing rights, IRC Section 7873.
- Revenue Ruling 94-65 - A tribal corporation organized under section 3 of the Oklahoma Welfare Act is not subject to federal income tax....
- Revenue Ruling 94-16 - An unincorporated Indian tribe... organized under section 17 of the Indian Reorganization Act is not subject to federal income tax.
- Revenue Ruling 81-295 - A federally chartered Indian tribal corporation has the same tax status as the Indian tribe.
- Revenue Ruling 74-205 - Replacement housing payments received by



individuals... are not includible in gross income.

- Revenue Ruling 63-136 - Benefit payments made to individuals undergoing training are not includible in the gross income of the recipients.
- Revenue Ruling 56-342 - Income held in trust which is derived from restricted Indian lands is exempt from Federal income tax.

To date, no formal voluntary correction programs exist. Voluntary correction programs could be a part of future planning for ITG as the knowledge base among Tribes improves. The development of an appropriate voluntary correction program might be a product of IRS-Tribal consultation.

### ***Opportunities***

Tribal consultation, additional education and consistent interaction will be required to encourage compliance with federal tax laws. Voluntary correction programs should be included in future planning for ITG as the knowledge base among Tribes improves. However, as a top priority, the IRS should engage Tribes in the process of developing a consultation policy. The Service should undertake a careful “scoping” of potential issues and concerns with regard to federal tax matters and make an effort to contact as many of the hundreds of federally recognized Tribes as possible to formulate an effective, informed Tribal consultation policy. In addition, reference should be made to the ACT report on development of a tribal consultation policy.

**ADVISORY COMMITTEE ON TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**V. EMPLOYEE PLANS SMALL BUSINESS ACCESS AND COMPLIANCE  
PROJECT GROUP**

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JUNE 21, 2002

# EMPLOYEE PLANS SMALL BUSINESS ACCESS AND COMPLIANCE PROJECT

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- 2. Develop an Employer "How-to" Manual
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- 4. Consider Developing Model Qualified-Plan Documents
- 5. Support Loosening of SEP and SIMPLE Minimum Eligibility Rules
- 6. Publicize the Tax Credit for Small Employer Plan Start-Up Costs
- 7. Publicize the Determination-Letter User-Fee Relief
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- 6. Consider Including Retirement-Plan Information on Employer Tax

Returns

7. Conduct Regular Compliance Surveys
8. Improve Assessment of Which Plans Need Examination and Education
9. Develop a Public-Use Database

# EMPLOYEE PLANS SMALL BUSINESS ACCESS AND COMPLIANCE PROJECT GROUP

The Employee Plans Small Business Access and Compliance Project Group respectfully submits the following report to the Advisory Committee on Tax Exempt and Government Entities (ACT) for transmittal to the Internal Revenue Service, Tax Exempt and Government Entities (TE/GE) Division, and its Employee Plans (EP) management staff.

## EXECUTIVE SUMMARY

The ACT created the Employee Plans Small Business Access and Compliance Project Group to study how to improve retirement plan coverage and compliance by small businesses. The goal of this project is to identify ways for the TE/GE Division to increase access by small businesses to retirement plans and to suggest ways the public and private sectors can work together to ensure that small businesses have adequate support in operating plans that are in compliance with the requirements.

### A. COVERAGE AMONG SMALL BUSINESSES

According to the U.S. Department of Labor, in 1999, 58% of all private wage and salary workers were employed by firms sponsoring pension plans.<sup>1</sup> The overall pension coverage rate in 1999 was 44%, including 47% for men and 40% for women. The pension coverage rate was 51% for full-time employees and 14% for part-time employees. The higher percentage of women workers employed on a part-time basis was a major factor in the lower overall coverage rate of women when compared to men. Among workers whose employers sponsored pension plans, three-fourths participated in the plans.

Coverage among small businesses is particularly dismal. Although some 40 million Americans are employed in businesses with 100 or fewer employees, only 8 million of them have pensions.<sup>2</sup> Of the 6 million businesses with 100 or fewer employees, only 17% or slightly more than 1 million provide some form of pension plan for their employees. Not surprisingly, just 24% of full-time workers in small businesses are covered, compared to 68% for workers in larger businesses (over 100 employees).

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<sup>1</sup> U.S. DEPARTMENT OF LABOR, *COVERAGE STATUS OF WORKERS UNDER EMPLOYER PROVIDED PENSION PLANS: FINDINGS FROM THE CONTINGENT WORK SUPPLEMENT TO THE FEBRUARY, 1999 CURRENT POPULATION SURVEY*, available at <<http://www.dol.gov/dol/pwba/public/programs/opr/CWS-Survey/hilites.html>>. Similar coverage data is reported in U.S. DEPARTMENT OF LABOR, *DELEGATE RESOURCES: THE 2002 NATIONAL SUMMIT ON RETIREMENT SAVINGS 5-8 (2002)*, available at <<http://www.saversummit.dol.gov/dol/pwba/public/programs/saversummit/PDF/SummitBackFinal.pdf>>. See also PENSION RIGHTS CENTER, *CONVERSATION ON COVERAGE (2001)*, available at <http://www.pensioncoverage.net/>; U.S. GENERAL ACCOUNTING OFFICE, *PRIVATE PENSIONS: IMPROVING WORKER COVERAGE AND BENEFITS*, Report No. GAO-02-225 (April 2002), available at <http://www.gao.gov/new.items/d02225.pdf>.

<sup>2</sup> U.S. Department of Labor, *Fact Sheet: Small Business Pension Coverage (October 2000)*.

## B. COMPLIANCE

Our current pension system has been described as “mind-numbingly” complex.<sup>3</sup> So it is no wonder that there are significant compliance problems in the retirement plan area. For example, a recent IRS survey of I.R.C. § 401(k) plans found that 44% of the plans surveyed failed to comply with one or more of the qualification requirements in the Internal Revenue Code.<sup>4</sup>

Much of the Employee Plans compliance work begins with information reported on Forms 5500, Annual Return/Report of Employee Benefit Plan. In addition to examining plans for compliance, the TE/GE Division works to identify nonfilers and get them to file Forms 5500. Finally, the TE/GE Division has been extraordinarily innovative in its efforts to promote compliance through its voluntary compliance correction programs (collectively known as the Employee Plans Compliance Resolution System [EPCRS]).

## C. RECOMMENDATIONS

The Project Group makes the following recommendations that are elaborated on in Part V of this report. Briefly, those recommendations include:

### INCREASING ACCESS TO RETIREMENT PLANS:

1. Provide “Choice of Plan” Guidance
2. Develop an Employer “How-to” Manual
3. Promote the Easiest Plans (payroll-deduction IRAs, SEPs, and SIMPLEs)
4. Consider Developing Model Qualified-Plan Documents
5. Support Loosening of SEP and SIMPLE Minimum Eligibility Rules
6. Publicize the Tax Credit for Small Employer Plan Start-Up Costs
7. Publicize the Determination-Letter User-Fee Relief
8. Publicize the Tax Credit for Elective Deferrals and IRA Contributions
9. Increase Outreach and Partnering Activities

### ENSURING COMPLIANCE WITH RETIREMENT-PLAN RULES:

1. Develop Employer Plan Compliance Checklists
2. Obtain and Use Lists of M&P and Volume-Submitter Adopters
3. Encourage Plan Operation Manuals

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<sup>3</sup> See, e.g., Ellen Hoffman, *Retirement Plans: Let's Clear the Maze*, BUSINESS WEEK ONLINE, March 7, 2002, available at [http://businessweek.com/bwdaily/dnflash/mar2002/nf2002037\\_6413.htm](http://businessweek.com/bwdaily/dnflash/mar2002/nf2002037_6413.htm).

<sup>4</sup> COMPLIANCE PROFILE OF SECTION 401(k) PLANS: RESULTS OF AN IRS SURVEY (2000), available at <http://www.irs.gov/> (click on Retirement Plans, and click on Compliance Profile of 401(k) Plans); but see U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: IRS CAN IMPROVE THE QUALITY AND USEFULNESS OF COMPLIANCE STUDIES, Report No. GAO-02-353 (April 2002), available at <http://www.gao.gov/new.items/d02353.pdf> (questioning the IRS methodology and suggesting that 44% “is probably at best an upper bound on the extent of noncompliance found in the study.” *Id.* at 4.)

4. Condition Form 5500 Filing Waiver on Initial Registration
5. Expand Form 5500 to Require Certification of Operational Compliance
6. Consider Including Retirement-Plan Information on Employer Tax Returns
7. Conduct Regular Compliance Surveys
8. Improve Assessment of Which Plans Need Examination and Education
9. Develop a Public-Use Database

## I. INTRODUCTION

At the inaugural working session of the Advisory Committee on Tax Exempt and Government Entities (ACT) on June 25 and 26, 2001, ACT determined that one of its projects would be to advise the Tax Exempt and Government Entities (TE/GE) Division about ways to increase access by small businesses to retirement plans and to suggest ways the public and private sectors can work together to ensure that small business employers have adequate support in operating plans that are in compliance with retirement-plan requirements.

The following ACT members worked on the project: Brian L. Anderson (project leader), Jonathan Barry Forman, and Craig Hoffman (collectively, the Project Group).

The IRS official who served as principal liaison to the Project Group was Mark F. O'Donnell, Director, Employee Plans (EP) Customer Education and Outreach, TE/GE. The Project Group received significant assistance from Mr. O'Donnell; from his Staff Assistant Peter McConkey; and from Carol D. Gold, Director, Employee Plans, TE/GE; her Executive Assistant Richard Westley; Paul Shultz, Director, EP Rulings and Agreements, TE/GE; Preston Butcher, Director, EP Examinations, TE/GE; James Flannery, EP Tax Law Specialist, TE/GE; Roger Kuehnle, EP Tax Law Specialist, TE/GE; Carlton Watkins, EP Tax Law Specialist, TE/GE; Nancy Payne, EP Customer Education and Outreach Analyst, TE/GE; John Schmidt, EP Customer Education and Outreach Analyst, TE/GE; Terry Holloway, EP Customer Education and Outreach Analyst, TE/GE; and Sarah Hall Ingram, Division Counsel/Associate Chief Counsel (TE/GE), IRS.

## II. ACTIVITIES OF THE PROJECT GROUP

### A. NOVEMBER 2001 WORKING SESSION

At the ACT working session on November 12 and 13, 2001, the Project Group heard presentations by three individuals from outside the IRS.

First, Patrick J. Purcell, a Specialist in Social Legislation from the Congressional Research Service, shared the results of his recent research on pension coverage among small employers.<sup>5</sup> Mr. Purcell noted that while most large employers B those

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<sup>5</sup> See Patrick J. Purcell & Paul J. Graney, *Pension Issues: Small-Employer Plans (CRS Report for Congress, August 15, 2001)*; see also Patrick J. Purcell, *Pension Coverage and Participation: Summary of Recent Trends (CRS Report for*

with 500 or more employees B sponsor retirement plans, the rate of plan sponsorship among small employers remains comparatively low. According to Census Bureau data, approximately 56% of all wage and salary workers age 16 and older in the private sector were employed by firms that sponsored a retirement plan in 1999.<sup>6</sup> Of course, not all workers in those firms are eligible to participate, and some choose not to participate. All in all, just 42% of the 111 million private sector workers in 1999 participated in an employer-sponsored retirement plan.<sup>7</sup>

Mr. Purcell noted, in particular, that small employers are much less likely than large employers to sponsor a plan. For example, only 20% of workers in firms with fewer than 10 employees were employed by firms with a retirement plan in 1999, and only 32% of workers in firms with 10 to 24 employees worked for an employer that sponsored a plan.<sup>8</sup> On the other hand, 60% of workers in firms with more than 100 employees worked for employers that sponsored plans (74% for workers in firms with more than 500 employees).<sup>9</sup>

Mr. Purcell cited a number of reasons why small businesses are unlikely to sponsor retirement plans. In particular, he noted that small firms are more likely to employ part-time and younger workers who tend to be more interested in cash compensation or health care benefits than in pension benefits. He also noted that uncertainty of revenue is a major reason why small employers are less likely to sponsor a retirement plan. In that regard, he noted that small firms have much lower survival rates than large firms. For example, among a sample of small firms that were in business in 1976, just two-thirds were still in business 2 years later, and only 31% survived 10 years.

Mr. Purcell emphasized the importance of educating both employers and employees about retirement plans and savings. "People need to be reminded that the average Social Security check for a retired worker is just \$830 a month," he said. Mr. Purcell was optimistic that such innovations as SIMPLE<sup>10</sup> plans and the new tax credit

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*Congress, updated November 6, 2001); Patrick J. Purcell, Retirement Savings and Household Wealth in 1998: Analysis of Census Bureau Data (CRS Report for Congress, May 8, 2001); and Patrick J. Purcell, Older Workers: Trends in Employment and Retirement (CRS Report for Congress, July 26, 2000).*

<sup>6</sup> Purcell & Graney, *supra* note 5, at 6. Similarly, 67% of workers between 21 and 64 worked for employers that sponsored retirement plans for at least some of their employees. *Id.*

<sup>7</sup> *Id.* at 7.

<sup>8</sup> *Id.* at 9. Workers employed year-round, full-time, did somewhat better. In 1999, 27% of workers in firms with fewer than 10 employees, and 42% of workers in firms with 10 to 24 employees, worked for an employer that sponsored a retirement plan. *Id.*

<sup>9</sup> *Id.*

<sup>10</sup> Savings Incentive Match Plans for Employees ("SIMPLEs") typically involve a type of IRA and are available only to employees with 100 or fewer employees. See *infra* subpart IV.B. In this report, the terms "SIMPLE" and "SIMPLE-IRA" are used interchangeably. It is also possible for an employer to set up a so-called "SIMPLE-401(k)" plan. These are relatively uncommon,



for small employers would help stimulate interest in retirement plans for small businesses.

Next, Teresa Turyn, Research and Education Associate with the Employee Benefit Research Institute (EBRI), discussed EBRI's 2001 Small Employer Retirement Survey.<sup>11</sup> Conducted annually since 1998, this survey of more than 600 small businesses helps explain why only 46% of full-time employees in small firms are covered by employment-based retirement plans compared to more than 79% of full-time employees in medium and large-sized firms. The survey focused on: (1) why many small employers do not offer plans; (2) how familiar nonsponsors are with various plans; and (3) what might motivate nonsponsors to offer plans.

Among the key reasons for not sponsoring a retirement plan: 19% of the small businesses surveyed reported that their employees prefer wages and/or other benefits; 18% reported that their revenues are too uncertain to commit to sponsoring a retirement plan; 15% reported that a large portion of their workers are seasonal, part-time, or high turnover; and 12% reported that the required contributions are too expensive.

The survey also shows that nonsponsors lack an understanding of the plan options available to them. For example, 52% of nonsponsors had never heard of simplified employee pensions (SEPs), and 34% had never heard of SIMPLE plans (Savings Incentive Match Plans for Employees). Nonsponsors reported that they would be motivated to set up a retirement plan if they could see an increase in business profits (44% of nonsponsors), plans with low administrative costs that require no employer contributions (35%), and business tax credits for starting a plan (23%). Thirty-eight percent of nonsponsors reported that they were likely to start a retirement plan in the next two years.

Among those small employers that already had plans, 95% offered only a defined contribution plan, and 5% offered both defined contribution and defined benefit plans. Most small employers that offered a plan offered a 401(k) plan (58%), but 22% offered a SIMPLE plan, and 13% offered a SEP. The most important reason given for offering a plan was the competitive advantage that sponsoring a retirement plan can give the business in employee recruitment and retention (25%). Other important reasons offered include: the positive effect on employee attitude and performance (19%); a perceived obligation to provide a retirement plan for their employees (16%); and the tax advantages for their employees (9%), key executives (6%), or themselves (4%).

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*however, and, consequently, they are largely outside the scope of this report.*

<sup>11</sup> See, e.g., Dallas Salisbury, Teresa Turyn & Ruth Helman, *EBRI Retirement Surveys: Retirement Confidence Survey (RCS), Minority RCS, and Small Employer Retirement Survey (SERS)*, EMPLOYEE BENEFIT RESEARCH INSTITUTE ISSUE BRIEF NO. 234 (2001) (a Summary of Findings for the 2001 Small Employer Retirement Survey (SERS) is available at <http://www.ebri.org/sers/2001/>).

Ms. Turyn also emphasized the importance of educating employers and employees about retirement savings and retirement plans. She mentioned EBRI's efforts to team up with the U.S. Department of Labor's Pension and Welfare Benefits Administration (PWBA) and with the Social Security Administration. She also noted the important activities of EBRI's sister organization, the American Savings Education Council (ASEC)<sup>12</sup> and the national summits on retirement savings.<sup>13</sup>

Debra Golding, from the PWBA, presented information about the Department of Labor's National Retirement Savings Education Campaign and the many PWBA publications directed to small employers and to employees.<sup>14</sup> For example, a one-page Employer Advisor charts the advantages and disadvantages of SEP-IRAs, Payroll Deduction IRAs, SIMPLE-IRAs, 401(k) plans, profit-sharing plans, defined benefit plans, and money purchase pension plans.<sup>15</sup> Ms. Golding also discussed the role of the national summits on retirement savings and the PWBA's many partnering efforts with the IRS, the Small Business Administration, and the U.S. Chamber of Commerce.

Of note, the Project Group learned that a working group of the Department of Labor's 1998 ERISA Advisory Council focused on how to encourage small businesses to establish pension plans.<sup>16</sup> The working group found "that there is a need for marketing to promote the creation of plans; for education of employers and employees; and for legislation to deal with regulatory obstacles, as well as the need to create tax and financial incentives."<sup>17</sup> And the working group offered recommendations on the following topics: repeal of the top-heavy rules; elimination of user fees; increasing the limits on benefits and contributions; increasing the limits on includable compensation; development of a national retirement policy; coalitions; tax incentives; and simplified defined benefit plans.

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<sup>12</sup> See <http://www.asec.org/>.

<sup>13</sup> See <http://www.saversummit.dol.gov/>.

<sup>14</sup> Many of these publications are more fully described *infra*, subpart III.B, and most are available at PWBA's website <http://www.dol.gov/dol/pwba/>. See also Paula A. Calimafde & Deborah A. Cohn, *Increasing Small Plan Formation: A Blueprint for Congressional Action for the Next Five Years*, in *NEW YORK UNIVERSITY 59TH INSTITUTE ON FEDERAL TAXATION B EMPLOYEE BENEFITS & EXECUTIVE COMPENSATION*, Chapter 14, pp. 14-1 to 14-39 (Alvin D. Lurie ed., 2001).

<sup>15</sup> Go to <http://www.dol.gov/dol/pwba/>, click on *Select a Retirement Plan* (under *Small Business Interactive Tools*), click on *Continue*, click on *savings program comparison chart*.

<sup>16</sup> See *ADVISORY COUNCIL ON EMPLOYEE WELFARE AND BENEFIT PLANS, REPORT OF THE WORKING GROUP ON SMALL BUSINESS: HOW TO ENHANCE AND ENCOURAGE THE ESTABLISHMENT OF PENSION PLANS* (1998), available at <http://www.dol.gov/dol/pwba/public/adccoun/smrpt1.htm>. See also Edward A. Morse, *Travails of the Entrepreneurial Ant: Reforming Tax-favored Retirement Saving for Small Business Owners*, 50 *DEPAUL LAW REVIEW* 49 (2000).

<sup>17</sup> *Id.* at 3.

The Project Group also learned about the recent TE/GE Division survey of compliance by 401(k) plans.<sup>18</sup> That study found that 44% of the plans surveyed failed to comply with one or more of the qualification requirements in the Internal Revenue Code. In the survey, which covered examinations of 1995 to 1997 plan years, the IRS examined 472 plans with 401(k) salary deferral arrangements and asked the examiners to identify the areas in which the plans had failed to comply with the Code. The IRS divided the plans into four categories, by the number of participants: small (0-16 participants), medium (17 to 53 participants), large (54 to 60,000 participants), and super large (at least 60,000 participants). According to the survey, 208 of the plans (44%) had one or more violations. The percentage of plans with violations was relatively the same across all four plan-size categories.

The most frequent failures related to:

1. Rollovers (participants were not given an option to elect direct rollover or were not given timely notice regarding eligible rollover distributions);
2. Nondiscrimination (not all eligible employees were included in actual deferral percentage (ADP) or actual contribution percentage (ACP) tests; no corrections were made to satisfy the tests; or benefits, rights, and features were not uniformly available);
3. Loans (the amortization rules or repayment schedules were not satisfied; collection procedures were not followed; or loan defaults were not properly reported);
4. Contingent benefits (other benefits were made contingent on salary deferrals);
5. Hardship distributions (participants were not required to obtain all other available distributions and loans; no objective criteria were in the plan; or deferrals were not suspended);
6. Top-heavy requirements (salary deferrals of non-key employees were counted toward employer minimum contributions); and
7. Annual addition limits (salary deferrals were included in compensation for section 415 purposes).

Although the survey did not find small employers any more noncompliant than large employers, it is fair to assume that small employers are less likely than large employers to obtain professional assistance regarding the establishment and administration of retirement plans. Anecdotal evidence indicates that small employers are more likely than large employers to not file required retirement-plan annual returns (Forms 5500, Annual Return/Report of Employee Benefit Plan). And it is certainly true that the kinds of retirement plans maintained by small employers are often different from the kinds of plans maintained by large employers. Therefore, IRS programs to ensure retirement-plan compliance may need to be structured differently for small employers than for large employers.

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<sup>18</sup> *COMPLIANCE PROFILE OF SECTION 401(k) PLANS: RESULTS OF AN IRS SURVEY, supra note 4; see also U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: IRS CAN IMPROVE THE QUALITY AND USEFULNESS OF COMPLIANCE STUDIES, supra note 4.*

In addition to continuing to study compliance by 401(k) plans, the TE/GE Division is developing new research samples for nonfilers, SEP adopters, and third-party administrators.<sup>19</sup>

## B. FEBRUARY 2002 WORKING SESSION

At the ACT working session on February 4 and 5, 2002, the Project Group focused more on the problems that some small employers have in complying with the rules applicable to retirement plans.

The Project Group inquired about master and prototype plan sponsors and the lists that such sponsors are required to maintain identifying the employers that adopt those plans. EP Director Carol Gold explained that the IRS has stopped asking for copies of the lists because the IRS did not do anything with the data on those lists.

The Project Group also inquired about employers that fail to file annual returns (Forms 5500). Preston Butcher, Director, EP Examinations, provided data about such “nonfilers” and about the kinds of filers whose returns have most frequently resulted in adjustments.

The Project Group wanted to know about the experience of the IRS with offering model plan documents. James Flannery, Tax Law Specialist, TE/GE, discussed the history of the model plan documents that were withdrawn from use in the early 1980s, when the first mass-submitter prototype plans became available. Mr. Flannery stated that it had been very difficult for the IRS, Chief Counsel, and the Treasury’s Office of Tax Policy to reach agreement regarding the language of the model plan documents. He also indicated that relatively few employers or other plan sponsors used the model documents: most sponsors found that the model plan documents were insufficiently flexible.

Carlton Watkins, Tax Law Specialist, TE/GE, spoke to the Project Group about the reorganization of the EP voluntary compliance program, with four managers: one in Brooklyn (for Northeast and Mid-Atlantic), one in Chicago (for Great Lakes), one in Dallas (for Gulf Coast), and one in Los Angeles (for Pacific Coast and Central Mountain). The TE/GE Division is in the process of developing an Employee Plans Compliance Resolution System (EPCRS) database that would be accessible only by authorized persons.

The Project Group asked about the possibility of further simplifying the IRS forms (Form Series 5305) that employers use to establish and maintain SEPs and SIMPLE

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<sup>19</sup> IRS EMPLOYEE PLANS, FY 2002 EMPLOYEE PLANS WORK PLAN: PROGRAM GUIDANCE 33 (October 11, 2001), available at <http://www.irs.gov/> (click on Retirement Plans, and click on FY 2002 EP Work Plan) (hereinafter 2002 EMPLOYEE PLANS WORK PLAN).

plans. Roger Kuehnle, Tax Law Specialist, TE/GE, discussed the forms and their formats and instructions.

The Project Group learned that much of the Employee Plans compliance work arises from the information reported on Forms 5500, Annual Return/Report of Employee Benefit Plan. Form 5500 is used to report information concerning employee benefit plans to the Department of Labor and to the IRS. In general, the administrator or sponsor of an employee benefit plan subject to ERISA must file the return and report information about the plan every year.<sup>20</sup> Of note, however, qualified retirement plans covering only one individual (or one individual and his spouse) can generally file a Form 5500-EZ as an alternative to Form 5500 and, if the total plan assets exceed \$100,000, need not file even the Form 5500-EZ.<sup>21</sup> Also, qualifying SEPs and SIMPLE plans need not file a Form 5500.<sup>22</sup>

For 1999, Forms 5500 were received with respect to 739,310 qualified plans holding more than \$4 trillion of assets and having 111 million participants.<sup>23</sup> In addition, Form 5500-EZ returns were received with respect to another 243,371 plans, holding almost \$75 billion of assets and having more than 227,000 participants.<sup>24</sup>

The Employee Plans Examinations Program closed 10,646 cases in fiscal year 2001.<sup>25</sup> Of note, a large percentage of cases are disposed of with no tax change.<sup>26</sup> The TE/GE Division regularly surveys its customers about their examination experiences, and customer satisfaction is high, regardless of whether they agree or disagree with the final outcome.<sup>27</sup> EP Examination has posted many of its examination guidelines on the IRS web site.<sup>28</sup>

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<sup>20</sup> I.R.C. §6058; ERISA §§104, 4065.

<sup>21</sup> Form 5500-EZ, Instructions.

<sup>22</sup> Labor Regulations §§2520.104-48 and -49; ERISA §101(g).

<sup>23</sup> This unpublished information came from TE/GE Division officials in February 2002. For public information, see, e.g., Table 14, Returns of Tax-Exempt Organizations and Employee Plans Examined, and Recommended and Average Additional Tax After Examination, by Type of Examination, Fiscal Year 2000 and Table 15, Returns of Tax-Exempt Organizations and Employee Plans Examined, by Type of Return, Fiscal Year 2000, both in the 2000 IRS DATA BOOK, Publication No. 55B (Table 14 is available at <http://www.irs.gov/pub/irs-soi/00db14eo.xls>, and Table 15 is available at <http://www.irs.gov/pub/irs-soi/00db15eo.xls>); see also U.S. Department of Labor, Pension and Welfare Benefits Administration, Abstract of 1996 Form 5500 Annual Reports, PRIVATE PENSION PLAN BULLETIN (No. 9, Winter 1999-2000), available at <http://www.dol.gov/dol/pwba/public/programs/opr/bullet1996/cover.htm> (hereinafter Abstract of 1996 Form 5500 Annual Reports).

<sup>24</sup> This unpublished information came from TE/GE Division officials in April 2002.

<sup>25</sup> *Id.*

<sup>26</sup> PACIFIC CONSULTING GROUP, INTERNAL REVENUE SERVICE CUSTOMER SATISFACTION SURVEY NATIONAL REPORT (WITHOUT CITE REFERENCES): EMPLOYEE PLANS EXAMINATION MARCH 2002 (COVERING JULY, AUGUST, AND SEPTEMBER 2001, WITH YEAR-TO-DATE RESULTS) 16 (2002).

<sup>27</sup> *Id.* at 19. In 2001, for example, about 71% of EP examination customers rated their overall satisfaction with the

In addition to examining filed returns, the TE/GE Division has worked with PWBA to develop a nonfiler initiative.<sup>29</sup> The central goal of this program is to ensure that plan sponsors timely file their Forms 5500. The TE/GE Division believes that getting plan sponsors to file regularly will also promote operational compliance. The TE/GE Division and PWBA are building a database to help locate nonfilers.<sup>30</sup>

In particular, the TE/GE Division and PWBA are curious about plan sponsors that have filed Forms 5500 in the past, but for some reason are no longer filing them. For example, the TE/GE Division wants to investigate why some employers fail to file a Form 5500, even though they are currently deducting pension contributions on, for example, a Form 1120, U.S. Corporation Income Tax Return.

Similarly, the TE/GE Division wants to match the determination letter requests it has received with the plans to which Forms 5500 relate. In that regard, the TE/GE Division has received determination letter requests from 135,453 plans that did not subsequently file a Form 5500.<sup>31</sup> It is assumed that many of these nonfilers are exempt from filing a Form 5500. As indicated above, for example, certain one-participant plans that hold less than \$100,000 in assets do not have to file. But the TE/GE Division

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*handling of their cases at 6 or 7 on a seven-point scale, and the overall satisfaction rating was 5.79.*

<sup>28</sup> See *EP Examination Guidelines and also Meet the Director, EP Examinations - an interview with Preston Butcher*, both available at <http://www.irs.gov/> (click on Retirement Plans, and look under Examination Program).

<sup>29</sup> See Notice 2002-23, 2002-15 INTERNAL REVENUE BULLETIN 1; see also U.S. Department of Labor, Fact Sheet: *Delinquent Filer Voluntary Compliance Program (March 2002)* available at [http://www.dol.gov/dol/pwba/public/pubs/0302fact\\_sheet.html](http://www.dol.gov/dol/pwba/public/pubs/0302fact_sheet.html).

<sup>30</sup> *Of note, a recent report by the U.S. General Accounting Office found that PWBA's lack of data on the extent of plans' noncompliance was undermining its enforcement efforts:*

*To date, PWBA has not systematically estimated the nature and extent of employee benefit plans' noncompliance with ERISA provisions. Therefore, PWBA cannot ensure that it is accurately identifying the areas in which it needs to focus to most efficiently and effectively allocate its limited resources. Furthermore, the lack of reliable data on overall plan noncompliance may reduce the effectiveness of PWBA's education and outreach programs. For example, if PWBA does not know the extent of a certain type of problem, it cannot gear its education and outreach to the plan sponsors to help correct and prevent further violations. In addition, the lack of such information may prevent PWBA from accurately measuring the overall performance of its enforcement program.*

*U.S. GENERAL ACCOUNTING OFFICE, PENSIONS AND WELFARE BENEFIT ADMINISTRATION: OPPORTUNITIES EXIST FOR IMPROVING MANAGEMENT OF THE ENFORCEMENT PROGRAM, Report No. GAO-02-232, at p. 18 (March 2002), available at <http://www.gao.gov/new.items/d02232.pdf>.*

*The General Accounting Office went on to offer a number of recommendations intended to strengthen the agency's oversight and enhance its ability to deploy its resources and better monitor the effectiveness of its operations. Id. at 3, 30-31.*

*Some of the General Accounting Office's concerns and recommendations may well be applicable to the TE/GE Division.*

<sup>31</sup> *This unpublished information came from TE/GE Division officials in February 2002.*

believes that many other nonfilers actually have a legal obligation to file a Form 5500, and some of those may also be out of compliance with the operational requirements of the Internal Revenue Code. All in all, the TE/GE Division expects that its new nonfiler program will significantly boost compliance by plan sponsors.<sup>32</sup>

Another compliance initiative involves building a database about SEPs and SIMPLE plans. Employee contributions to SEPs and SIMPLE plans are designated as such in box 13 on IRS Form W-2, Wage and Tax Statement. From this and other information, the TE/GE Division hopes to build a database about SEPs and SIMPLE plans and develop a strategy for helping ensure compliance by SEP and SIMPLE plan sponsors.

TE/GE Division officials also expressed concern about how the high volume of determination letters saps resources that might otherwise be used for compliance. The TE/GE Division has projected that it will receive approximately 150,000 determination letter applications during fiscal years 2002 and 2003 (up from about 30,000 a year),<sup>33</sup> and plan sponsors will again have to request new determination letters when they amend their pension plans to comply with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). In that regard, the IRS released a white paper describing 10 possible long-range options for changing the determination letter process.<sup>34</sup> Employee Plans officials have been discussing these alternatives at professional conferences and meetings, and they welcome comments from all interested employers, participants, and employee benefits practitioners.

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<sup>32</sup> Similarly, the TE/GE Division hopes to improve compliance with respect to IRAs by developing a database of information from Form 5498, IRA and Coverdell ESA Information.

<sup>33</sup> This unpublished information came from TE/GE Division officials in April 2002. See also Table 20, *Determination Letters Issued on Employee Benefit Plans, by Type and Disposition of Plan, Fiscal Year 2000 in the 2000 IRS DATA BOOK*, Publication No. 55B, available at <http://www.irs.gov/pub/irs-soi/00db20ep.xls>.

<sup>34</sup> *IRS EMPLOYEE PLANS, THE FUTURE OF THE EMPLOYEE PLANS DETERMINATION LETTER PROGRAM: SOME POSSIBLE OPTIONS* (August 8, 2001), available at <http://www.irs.gov/> click on Retirement Plans, and click on white paper [under Determination Letter Program]. For example, one possibility would be to eliminate the determination letter process and, instead, provide employers with model pension plan documents. Employers could adopt those model plans or rely on practitioners' opinions that their pension plans satisfy the qualification requirements.

*Another alternative would be to eliminate determination letters for individually designed plans but continue to issue determination letters for master and prototype plans. A third possibility would be to replace the determination letter process with a third-party certification system in which authorized practitioners certify that an employer's plan meets all of the qualification requirements.*

*A fourth alternative would be to replace the determination letter process with a registration system that includes a certified compliance checklist. The checklist would request specific information that would indicate whether the plan is qualified in form and operation, and it would have to be signed under penalty of perjury.*

*Other alternatives would reduce the need for repeatedly securing determination letters for the same plan. For example, the IRS might issue determination letters only for initial plan adoption and for termination.*

Employee Plans has also been extraordinarily innovative in its efforts to promote voluntary compliance. The Voluntary Compliance Program (Employee Plans Compliance Resolution Program [EPCRS]) involves a number of correction programs for sponsors of retirement plans that have experienced compliance violations, and the program is designed to help employers preserve the tax qualified status of their plans.<sup>35</sup> The Voluntary Compliance Program closes about 1,000 cases a year.<sup>36</sup>

### C. APRIL 2002 WORKING SESSION

At the ACT working session on April 22 and 23, 2002, the Project Group received input from IRS officials and other ACT members about an earlier draft of this report, and the Project Group worked on finalizing this report.

EP Director Carol Gold advised that Employee Plans has a working definition of non-compliance, as follows:

EP non-compliance exists under any of the following situations:

- Failure of the plan document to comply with requirements for tax qualified status;
- Significant failure to operate the plan in a manner consistent with requirements for tax qualified status;
- Failure to report and pay applicable excise taxes;
- Failure to file information returns required by the Internal Revenue Code; and
- Failure to fund the plan appropriately.

Nancy Payne, EP Customer Education and Outreach Analyst, TE/GE, demonstrated the operation of the Retirement Plans portion of the IRS website (<http://www.irs.gov/ep>) and discussed its future development. John Schmidt, EP Customer Education and Outreach Analyst, TE/GE, discussed the development of Employee Plans outreach materials and pamphlets. Terry Holloway, EP Customer Education and Outreach Analyst, TE/GE, demonstrated the soon-to-be-released IRS Resource Guide for Tax-sheltered Annuities and 457 Plans CD-ROM (IRS Publication No. 3767, forthcoming 2002).

### D. JUNE 2002 PUBLIC MEETING AND THEREAFTER

This report was released at the ACT public meeting on June 21, 2002. The TE/GE Division, ACT, and the Project Group welcome your comments.

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<sup>35</sup> See, e.g., *Revenue Procedure 2001-17, 2001-7 INTERNAL REVENUE BULLETIN 589*, available at <http://www.irs.gov/pub/irs-irbs/irb01-07.pdf>. See also *Meet the Manager, EP Voluntary Compliance - an interview with Joyce Kahn*, available at <http://www.irs.gov/> (click on Retirement Plans, and click on interview [under Employee Plans Compliance Resolution System {EPCRS}]).

<sup>36</sup> 2002 EMPLOYEE PLANS WORK PLAN, *supra* note 19, at 24.



### III. PUBLICATIONS FOR SMALL BUSINESSES

#### A. IRS PUBLICATIONS

The IRS has numerous publications to help small businesses that are interested in retirement plans. In general, publications are available on paper, on the IRS website, and in CD-ROM format.

For example, some relevant IRS publications include:

- Retirement Plans for Small Business, IRS Publication No. 560;
- Pension and Annuity Income, IRS Publication No. 575; and
- Individual Retirement Arrangements (IRAs), IRS Publication No. 590.

In addition, the IRS publishes numerous forms, with instructions, for use by small businesses interested in setting up a retirement plan. For example, some relevant forms include:

- **5304-SIMPLE** (to establish a SIMPLE plan not limited to a designated depository);
- **5305-SEP** (to establish a SEP);
- **5305-SIMPLE** (to establish a SIMPLE plan limited to a designated depository); and
- **5305A-SEP** (to maintain a salary-reduction SEP established before 1997).

These forms are widely available in print and can be ordered or downloaded from the IRS website.<sup>37</sup>

On the newly restructured IRS website (<http://www.irs.gov/>), there is a direct link to Retirement Plans (under contents) and, from there, a link to Retirement Plans for Small Businesses. The latter contains the presentation Don't Make Retirement a Taxing Event and links to detailed explanations of various kinds of retirement plans (and rules related to contributions, employer deductions, salary deferrals, distributions, prohibited transactions, reporting requirements, and qualification rules).<sup>38</sup> Similar materials are included on the IRS Small Business Resource Guide CD-ROM (IRS Publication No. 3207).

The IRS publications tend to be oriented towards filing and compliance concerns rather than towards advising employers about how to establish or maintain plans.

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<sup>37</sup> For a full list of Employee Plans forms and publications, go to <http://www.irs.gov/> (click on Retirement Plans [under contents], and click on EP Forms & Publications).

<sup>38</sup> See *Simplified Employee Pensions (SEPs), Savings Incentive Match Plan for Employees (SIMPLE) Plans, Keogh (H.R. 10) Plans, and Individual Retirement Plans (IRAs)*, available at <http://www.irs.gov/> (click on Retirement Plans [under contents], and click on look [under Retirement Plans for Small Business]).

## B. U.S. DEPARTMENT OF LABOR PUBLICATIONS

The Pension and Welfare Benefits Administration (PWBA) of the U.S. Department of Labor offers a wide variety of publications and services to assist employers interested in retirement plans. The PWBA website is at <http://www.dol.gov/dol/pwba/>. On that website, for example, the Small Business Advisor is an interactive program that provides answers to a variety of questions about retirement savings options for small business employers and helps employers choose the most appropriate type of retirement plan.<sup>39</sup> Similarly, Small Business Retirement Savings Programs provides a matrix of retirement-plan designs and their features.<sup>40</sup>

The PWBA website also offers excellent how-to pamphlets: Simplified Employee Pensions (SEPs): What Small Businesses Need To Know; and Savings Incentive Match Plans For Employees of Small Employers (SIMPLE): A Small Business Retirement Savings Advantage.<sup>41</sup> The PWBA also runs a Retirement Savings Education Campaign,<sup>42</sup> and PWBA is instrumental in organizing the periodic national summits on retirement savings.<sup>43</sup>

Also, the Department of Labor, the U.S. Small Business Administration, the U.S. Chamber of Commerce, and Merrill Lynch together sponsor the website <http://www.selectretirementplan.org/>. On this website, there are links to:

- Plans and Advantages, which gives a quick overview of various plans and their benefits;
- Select a Plan, which is an interactive tool for selecting a retirement plan;
- Retirement Planning Basics, which provides a general guide for employers and their employees; and
- Resources, which offers other helpful links.

## C. AMERICAN SAVINGS EDUCATION COUNCIL PUBLICATIONS

The American Savings Education Council (ASEC) is a coalition of private and public sector institutions that raises public awareness about the need for retirement savings. The coalition includes the Department of Labor, the Securities and Exchange Commission, and the Pension Benefit Guaranty Corporation; but it does not yet include the IRS.

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<sup>39</sup> Go to <http://www.dol.gov/dol/pwba/>, click on *Small Business Advisor* (under *Small Business Interactive Tools*).

<sup>40</sup> Go to <http://www.dol.gov/dol/pwba/>, click on *Select a Retirement Plan* (under *Small Business Interactive Tools*).

<sup>41</sup> Go to <http://www.dol.gov/dol/pwba/>, click on *Publications/Reports*.

<sup>42</sup> See, e.g., *A Financial Warmup*, available at <http://www.dol.gov/dol/pwba/public/pubs/part2.pdf>.

<sup>43</sup> See, e.g., *The 2002 National Summit on Retirement Savings* web site <http://www.saversummit.dol.gov/>.

ASEC has a variety of brochures and worksheets about retirement savings, which are also available at its website [www.asec.org](http://www.asec.org). For example, ASEC's TOP 10 WAYS to Beat the Clock and Prepare for Retirement has: links to the PWBA and its books about private pensions; the IRS-publications telephone number (but not a link) for IRS Publication 590; and ASEC's own Small Business Quiz. Also, ASEC's How Do I Get There from Here provides advice for Finding a Qualified Professional and A Guide for Do-it Yourselfers.

#### IV. OVERVIEW OF PLANS FOR SMALL BUSINESSES

Retirement plans are tax-favored plans that enable small employers and their employees to set aside money for retirement.<sup>44</sup> They include:

- SEPs (Simplified Employee Pensions);
- SIMPLE plans (Savings Incentive Match Plans for Employees);
- Qualified plans (often referred to as H.R. 10 plans or Keogh plans when established by self-employed individuals); and
- Individual retirement accounts (IRAs).

##### A. SIMPLIFIED EMPLOYEE PENSIONS (SEPs)

A simplified employee pension (SEP) is a plan, established under I.R.C. §408(k), which allows employers to make contributions on behalf of themselves and their employees to IRAs. SEPs are sometimes referred to as SEP-IRAs because the SEP contributions are made to IRAs. Employers must contribute a uniform percentage of pay for each eligible employee. Employer contributions are limited to the lesser of 25% of an employee's annual salary or \$40,000 (for 2002). SEPs can be established by most employers, including individuals who are self-employed.

SEPs have low start-up and operating costs and can be established using a single quarter-page form (Form 5305-SEP). Businesses are not locked into making contributions every year. The employer can decide how much to put into a SEP each year offering some flexibility when business conditions vary.

Employees are always 100% vested in contributions to their IRAs under the SEP. Even when employees leave their employer, they keep their IRAs.

##### B. SIMPLE PLANS

SIMPLE plans (Savings Incentive Match Plans for Employees) are the result of relatively new legislation – the Small Business Job Protection Act of 1996 – which

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<sup>44</sup> This part follows U.S. DEPARTMENT OF LABOR, *SIMPLE RETIREMENT SOLUTIONS FOR SMALL BUSINESS* <http://www.dol.gov/dol/pwba/public/pubs/savings.htm> and IRS PUBLICATION No. 560, *RETIREMENT PLANS FOR SMALL BUSINESS (INCLUDING SEP, SIMPLE, AND QUALIFIED PLANS)* (2001).

created I.R.C. §408(p). They typically involve a type of IRA and are available only to employers with 100 or fewer employees who received at least \$5,000 of compensation from the employer for the preceding year.<sup>45</sup>

A SIMPLE plan allows employees to contribute a percentage of their salary and to obtain matching or fixed contributions from the employer. Under SIMPLE plans, employees can contribute up to a certain dollar amount each year (\$7,000 for 2002). Employers can either match employee contributions dollar for dollar -- up to 3% of the employee's pay -- or make a fixed contribution equal to 2% of pay for all eligible employees instead of a matching contribution.

SIMPLE plans are easy to set up. The employer fills out a short form (Form 5304-SIMPLE or Form 5305-SIMPLE). Administrative costs are low. Much of the paperwork is done by the financial institution that provides the IRAs to which the contributions are deposited. Employers may choose either to permit employees to select the financial institution to which their contributions will be sent (Form 5304-SIMPLE), or to send contributions for all employees to one financial institution (Form 5305-SIMPLE).

Employees are 100% vested in contributions to their IRAs under SIMPLE plans. Even when employees leave their employer, they keep their IRAs.

### C. QUALIFIED PLANS

A plan that satisfies I.R.C. §401(a) is called a qualified plan. Every employer can set up a qualified plan of some kind.

A qualified plan set up by self-employed individuals (such as a sole proprietor or a partnership) is sometimes called a Keogh plan or HR-10 plan. A self-employed individual is treated as both an employer and an employee. A common-law employee or a partner, alone, is not an employer and cannot set up a qualified plan.

There are two basic kinds of qualified plans B defined contribution plans and defined benefit plans B and different rules apply to each.

#### 1. Defined Contribution Plans

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to the participant's account. Benefits are also affected by any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to the participant's account. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan (or, less commonly, a stock bonus plan).

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<sup>45</sup> It is also possible for an employer to set up a so-called "SIMPLE-401(k)" plan. These are relatively uncommon and are largely outside the scope of this report. Consequently, in this report, the term "SIMPLE" refers only to a SIMPLE-IRA.

a. Profit-sharing plans

A profit-sharing plan was originally envisioned as a plan for sharing business profits with employees. Under current law, however, a business is not actually required to have profits in order to make a contribution to the plan.

For many businesses, one of the most appealing features of a profit-sharing plan is that the employer contribution obligation is not fixed. The amount contributed can be varied from year-to-year. As a result, an employer has more flexibility in making contributions to a profit-sharing plan than to a money purchase pension plan or a defined benefit plan. Although it is not necessary that the employer contribute every year, IRS regulations do require substantial and recurring contributions. Also, the plan must have a definite formula for allocating the contributions among the eligible participants.

A profit-sharing plan that includes a cash or deferred arrangement under I.R.C. §401(k) is generally referred to as a 401(k) plan. Such salary deferral plans have become a widely-accepted savings vehicle for small businesses. Today, an estimated 25 million American workers are enrolled in 401(k) plans that hold total assets of about \$1 trillion.

Employees contribute a percentage of their pay to the 401(k) plan on a tax-deferred basis through payroll deductions. Employers might also contribute to an employee's 401(k) account by matching employee contributions, usually up to a percentage of an employee's pay. In 2002, the limit on salary deferrals is \$11,000 (although employees who are at least 50 years old by the end of the year may be entitled to make an additional \$1,000 contribution if permitted under the terms of the plan).

While more complicated than IRAs and SIMPLE plans, 401(k) plans offer higher contribution limits and so permit employees to accumulate greater savings.

Employers also may make discretionary profit-sharing contributions that are not allocated on a matching basis. These contributions are divided based on an allocation formula contained in the plan. The most common allocation formula is *pro rata* based on covered compensation. Under this approach, each eligible participant for the year generally gets the same percentage of pay contributed by the employer, but the employer can change the percentage or amount from year to year.

b. Money purchase pension plans

Contributions to a money purchase pension plan are fixed and are not based on business profits. For example, a money purchase plan might require employer contributions equal to 10% of compensation of eligible employees. With few exceptions, employees cannot make pre-tax salary-deferral contributions to money purchase pension plans.

## 2. Defined Benefit Plans

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions. Generally, to maintain a defined benefit plan, an employer needs ongoing assistance from professional employee-benefits practitioners.

### E. INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)

Even if an employer does not want to adopt a retirement plan, it can promote retirement savings by encouraging employees to contribute to traditional or Roth individual retirement accounts or annuities (IRAs).<sup>46</sup> Employees who have their paychecks directly deposited into a bank or other financial institution account can, of course, arrange for the financial institution to direct a set sum each month to an IRA at the financial institution.

#### 1. Traditional IRAs and Roth IRAs

Under present law, an individual may make tax-deductible contributions to a traditional IRA or non-tax-deductible contributions to a Roth IRA up to the lesser of earned income or a certain dollar amount (\$3,000 for 2002).<sup>47</sup> Contributions to traditional IRAs are limited if the individual is an active participant in an employer-sponsored retirement plan and the individual and his/her spouse have compensation in excess of certain limits.<sup>48</sup> Similarly, contributions to Roth IRAs are limited if the individual and his/her spouse have compensation in excess of certain other limits. In the case of a married couple, special rules sometimes also permit IRA contributions to be made for the non-working spouse. Starting in 2002, an individual who has attained age 50 before the end of the taxable year may be able to make "catch-up" contributions to an IRA, up to certain dollar amounts (\$500 for 2002).<sup>49</sup>

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<sup>46</sup> This section follows: JOINT COMMITTEE ON TAXATION, *PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED CONTRIBUTION PLANS AND OTHER RETIREMENT ARRANGEMENTS (JCX-9-02) 19-21 (2002)*, available at <http://www.house.gov/jct/x-9-02.pdf>.

<sup>47</sup> The dollar limit on IRA contributions is \$3,000 for 2002 through 2004, \$4,000 for 2005 through 2007, and \$5,000 for 2008. After 2008, the limit is adjusted for inflation in \$500 increments.

<sup>48</sup> In 2002, for example, if an individual is an active participant in an employer-sponsored retirement plan, the deduction is phased out if the individual and his spouse file a joint return and their adjusted gross income is between \$54,000 and \$64,000. To the extent the active-participant rules prevent an individual from making a tax-deductible contribution, however, the individual can make a non-deductible contribution, subject to the overall dollar limits described in note 47.

<sup>49</sup> The additional amount permitted for catch-up contributions to an IRA is \$500 for 2002 through 2005 and \$1,000 for 2006 and thereafter.

Amounts held in a traditional IRA are generally taxable when withdrawn, and early withdrawals generally are subject to the same additional 10-percent tax that applies to early distributions from a qualified retirement plan.

## 2. Payroll-Deduction IRAs

Under present law, an employer can establish a payroll-deduction IRA program to help employees save for retirement through their own IRAs.<sup>50</sup> These work much like the federal savings bond program. Under a payroll-deduction program, an employee may contribute to an IRA by electing to have the employer withhold amounts from the employee's paycheck and forward those amounts to the employee's IRA. Payroll-deduction contributions are included in the employee's wages for the taxable year, but (in the case of contributions to traditional IRAs) the employee may deduct the contributions on the employee's tax return, subject to the usual limits.

These payroll-deduction IRA programs are usually exempt from the provisions of Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), which impose reporting, disclosure, and fiduciary requirements. Department of Labor rulings and regulations provide an exception from those ERISA requirements for a payroll-deduction IRA program in which no contributions are made by the employer, participation is completely voluntary for employees, the employer does not endorse any part of the program (though the employer may publicize the program, collect contributions, and remit them), and the employer receives no form of consideration other than reasonable compensation for services actually rendered in connection with payroll deductions.<sup>51</sup>

## V. RECOMMENDATIONS

At the ACT working sessions (November 12 and 13, 2001; February 5 and 6, 2002; and April 22 and 23, 2002), the Project Group identified a number of actions that the TE/GE Division could take to increase small employer access to retirement plans and maintain compliance with the retirement-plan requirements.

### A. INCREASING ACCESS TO RETIREMENT PLANS

#### 1. Provide "Choice of Plan" Guidance

Small employers need help identifying what kinds of plans are available and what kinds are best suited to satisfy the employer's goals. Currently, a useful website with interactive questions and answers providing such help is

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<sup>50</sup> This description follows JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL (JCS-2-00) 119-120 (2000), available at <http://www.house.gov/jct/s-2-00.pdf> (hereinafter DESCRIPTION OF PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL).

<sup>51</sup> *Id.* at 119; Department of Labor Interpretive Bulletin 99-1, 64 FEDERAL REGISTER 32,999 (June 18, 1999); Department of Labor Regulation §2510.3-2. On the other hand, a payroll-deduction IRA program may be subject to Title I of ERISA if, for example, the employer makes contributions to the program or the employer receives more than reasonable compensation for services rendered in connection with payroll deductions.

<http://www.selectaretirementplan.org/>. The website is cosponsored by the U.S. Department of Labor, the U.S. Small Business Administration, the U.S. Chamber of Commerce, and Merrill Lynch. The Project Group recommends that the TE/GE Division obtain IRS cosponsorship of the website (and promote it on the IRS website).

Improving the website is not enough, however. There is a need for a plain-language “choice-of-plan” manual that performs a function similar to that of the <http://www.selectaretirementplan.org/> website. The Project Group recommends that the TE/GE Division prepare such a manual in writing and also post it on the IRS website. In preparing such a manual, TE/GE should solicit the assistance of other IRS Divisions, Chief Counsel, other governmental entities (such as the Department of Labor and the Small Business Administration), and nongovernmental partners. The manual should be written not just for businesses but also for governmental and tax-exempt organizations that need help understanding and choosing among not only the usual retirement plans but also 457(b) plans and 403(b) tax-sheltered annuity plans, acknowledging the role that state law plays in the formation of governmental plans.<sup>52</sup>

The Project Group is aware that the TE/GE Division is already in the process of developing a tri-fold hand-out with a “choice-of-plan” chart. Such a hand-out should be very useful if it is widely disseminated.

## 2. Develop an Employer “How-to” Manual

Small employers need help with the basics of setting up and administering retirement plans. Small employers generally obtain such help from professional advisors (such as accountants and attorneys) and retirement-plan providers. But the quality of the help varies widely. And some small employers prefer to act without professional advice because of its cost. Also, some retirement-plan providers are familiar only with the retirement-plan products that they sell.

In the opinion of the Project Group, there is a significant need for a “how-to” manual for employers that establish and maintain retirement plans. The manual would contain checklists and explain, in plain language, what needs to be done to initially establish a retirement plan and to later administer it properly each year. The manual would help employers monitor whether their retirement-plan service providers are performing effectively. Professional advisors and retirement-plan providers could use such a manual and also provide it to their employer clients/customers. Employers who prefer to act without professional advice could use such a manual to learn the basics of plan establishment and administration.

The Project Group recommends that the TE/GE Division prepare and provide such a “how-to” manual in writing and on the IRS website. Assistance for this project

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<sup>52</sup> *The Project Group notes with approval that EP Customer Education and Outreach is already developing a range of materials dealing with the “Life Cycle of a Retirement Plan.” The current strategy is to develop materials on considering, establishing, operating, and terminating a retirement plan. The first new brochure is called “Choosing a Retirement Plan for Your Small Business.”*



could be obtained from other IRS Divisions, Chief Counsel, other governmental entities (such as the Department of Labor and the Small Business Administration), and nongovernmental partners. Perhaps separate manuals would be appropriate for different kinds of retirement plans: SEPs, SIMPLE plans, profit-sharing plans without 401(k) salary deferrals, 401(k) plans, etc.

3. Promote the Easiest Plans (payroll-deduction IRAs, SEPs, and SIMPLEs)

As indicated in Part III, above, the IRS, the Department of Labor, the Small Business Administration, and private-sector organizations such as the U.S. Chamber of Commerce and the American Savings Education Council (ASEC) have developed a variety of materials that explain the various retirement savings vehicles and encourage retirement savings. Still, there is much more that the IRS could do to encourage the development of retirement savings plans by small businesses. In particular, the IRS is uniquely situated to develop materials that would readily enable small businesses to set up payroll-deduction IRAs, SEPs, and SIMPLE plans.

At present, most IRS publications are compliance-oriented. For the most part, IRS publications relating to retirement plans are designed to help employers understand annual contribution limits, deduction limits, reporting requirements, and plan qualification rules. Other publications are designed to help individuals understand IRA rules or how pension and annuity payments should be reported on individual income tax returns.

The Project Group believes that the IRS, through the TE/GE Division (and its partners inside and outside of government), should develop more materials that encourage the formation of retirement plans. In particular, these materials should explain the plans that are likely to be most appropriate for small employers. The Department of Labor's PWBA already provides some excellent explanatory pamphlets about SEPs and SIMPLE plans. The TE/GE Division should develop its own pamphlets or help disseminate the PWBA pamphlets in the small-employer community. The approach should be more like: "We'd like you to have a retirement plan. Here's how to do it."

In particular, the TE/GE Division should promote payroll-deduction IRAs. These plans can provide modest retirement savings for employees whose employers cannot afford to maintain plans that involve employer contributions. IRA providers generally devote little attention to promoting payroll-deduction IRAs (probably because the dollar amounts of contributions are so small). Also, because payroll-deduction IRAs are not typically covered by ERISA, the Department of Labor has not been very interested in promoting them. Consequently, the Project Group believes that it falls upon the IRS, through the TE/GE Division (and its partners inside and outside of government) to promote payroll-deduction IRAs.<sup>53</sup>

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<sup>53</sup> In that regard, the legislative history of the Taxpayer Relief Act of 1997 encourages the Secretary of the Treasury to publicize and promote the availability of payroll-deduction IRAs. See, e.g., DESCRIPTION OF PRESIDENT'S FISCAL YEAR 2001

IRAs are likely to become even more important retirement-plan vehicles as their contribution limits increase in the coming years. Starting in 2002, individuals can generally contribute and deduct up to \$3,000 to an IRA, and spouses can generally contribute and deduct a similar amount.<sup>54</sup> The maximum contribution amount is scheduled to increase to \$4,000 in 2005 and \$5,000 in 2008 and thereafter.<sup>55</sup> Therefore, the typical husband and wife will eventually be able to save \$10,000 per year in their IRAs (and \$12,000 per year if both of them are over age 50). Financial planners usually suggest that the easiest way to save is through a payroll-deduction mechanism: "If you don't see the money, you won't spend it."<sup>56</sup>

The new tax credit for elective deferrals and IRA contributions might also encourage greater use of payroll-deduction IRAs.<sup>57</sup> Starting in 2002, certain low- and moderate-income individuals can claim a credit of up to \$1,000 for certain qualified retirement savings contributions. The credit is equal to a percentage (50%, 20%, or 10%) of up to \$2,000 of qualifying contributions.

In addition, Congress might consider requiring employers without retirement plans to offer payroll-deduction IRAs to interested employees. It might also make sense to allow employers to adopt an automatic-enrollment arrangement for payroll-deduction IRAs. The 401(k) plan automatic-enrollment option B which defers a portion of salary unless the employee elects otherwise B has already shown great results.<sup>58</sup> Employers who adopt such arrangements can boost employee participation in the plans.

Another way for Congress to encourage payroll-deduction IRAs would be to allow employees to exclude allowable contributions from their income; consequently,

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*BUDGET PROPOSAL, supra note 50, at 119-21.*

<sup>54</sup> *Individuals over 50 by the end of the year can contribute another \$500 a year in 2002 through 2005.*

<sup>55</sup> *Individuals over 50 by the end of the year will be allowed to contribute another \$1,000 a year in 2005 and thereafter.*

<sup>56</sup> *See, e.g., Jane Bryant Quinn, 7 Steps for Climbing Out of a Budget Hole, WASHINGTON POST, September 2, 2001, at H2, available at <<http://www.washingtonpost.com/wp-dyn/business/columns/personalfinance/quinnjanebryant/>>. Many individuals eligible to contribute to an IRA do not. One reason is that some individuals wait until the end of the year to set aside the money and then find that they do not have sufficient funds to do so. Payroll deductions allow individuals to plan ahead and save smaller amounts each pay period. Payroll-deduction contributions are tax-deductible by an individual to the same extent as other contributions to traditional IRAs.*

<sup>57</sup> *I.R.C. §25B.*

<sup>58</sup> *See, e.g., The Vanguard Center for Retirement Research, Automatic Enrollment: The Benefits and Costs of Adoption, COMMENTARY, May 2000, available at [http://institutional.vanguard.com/pdf/automatic\\_enrollment.pdf](http://institutional.vanguard.com/pdf/automatic_enrollment.pdf); Automatic Enrollment Increases Participation in Section 401(k) Plans, PSCA Survey Says, 28 BNA PENSION & BENEFITS REPORTER 1214 (April 24, 2001); Revenue Ruling 2000-8, 2000-1 CUMULATIVE BULLETIN 617.*

these contributions would not be taxed as earned and would not be reported as income on the employee's Form W-2, Wage and Tax Statement.<sup>59</sup>

#### 4. Consider Developing Model Qualified-Plan Documents

Qualified plan documents fall into two basic categories: individually designed plans that are typically prepared for a single employer and pre-approved plans that are typically designed for adoption by more than one employer. Pre-approved plans include both: (a) master and prototype plans (M&P), which are designed and sponsored by eligible organizations such as financial institutions; and (b) volume-submitter plans, which are based on practitioner-or-institution-designed specimen plans. An employer that adopts a pre-approved plan can, for many purposes, rely on the IRS approval letter issued to the M&P sponsor or volume submitter, if the adopted plan is identical to the M&P or specimen plan and the only options chosen were permitted under the terms of the approved plan.<sup>60</sup>

Pre-approved plans have become the most prevalent kinds of plan documents. They are generally less expensive than individually designed plan documents. They provide the kind of standardization that facilitates administration by third parties.

Nevertheless, pre-approved plan documents can have some disadvantages. For example, M&P plan documents are generally very lengthy, with all kinds of optional language written into them, so that they can accommodate most of the provisions that any typical employer might desire. Accordingly, such documents can be difficult for the adopting employers to understand.

Another potential disadvantage is that when an employer adopts a pre-approved plan document that is sponsored by a financial institution, the employer generally must leave the document behind and adopt a new one each time that the employer switches to a different financial institution. The new institution "maps" the provisions of the prior plan document into the provisions of its new plan document. Sometimes the "mapping" is done incorrectly, resulting in errors that can affect the qualification of the new plan document. The "mapping" would be unnecessary if the employer were to use a plan document that was not tied to a particular financial institution.

The Project Group notes that the TE/GE Division has recently been providing model plan language for plan provisions affected by new rules. For example, Notice 2001-57<sup>61</sup> provides sample plan amendments for changes to the plan qualification requirements under I.R.C. §401(a) that were made by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).<sup>62</sup> Similarly, other publications provide

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<sup>59</sup> See, e.g., *DESCRIPTION OF PRESIDENT'S FISCAL YEAR 2001 BUDGET PROPOSAL*, *supra* note 51, at 119-21.

<sup>60</sup> *Announcement 2001-77, 2001-30 INTERNAL REVENUE BULLETIN 83.*

<sup>61</sup> *2001-38 INTERNAL REVENUE BULLETIN 279.*

<sup>62</sup> *Public Law No. 107-16, 115 STATUTES AT LARGE 108 (2001).*

sample forms and certifications.<sup>63</sup> All three members of the Project Group applaud such guidance and model language.

In addition, the Project Group, with significant input from other ACT members, considered whether or not the TE/GE Division (with the assistance of governmental and nongovernmental partners) should develop its own model plan documents that employers could adopt. An IRS model plan could operate like a pre-approved plan, so that an adopting employer would not need to file a determination letter request. An IRS model plan, even if not adopted wholesale, could provide sample language that is more complete and integrated than the “List of Required Modifications” that is currently applied to M&P plans.

Supporters of having the IRS draft model plans believe that such documents would be used by many small employers, especially if the IRS plans are well drafted to be flexible and readable (e.g., liberally incorporating Code provisions by reference). Supporters also believe that IRS model plans would likely be supported by most financial institutions and third-party administrators, because such organizations generally make their money from the management of investments and administration of plans, rather than from the sale of plan documents. Theoretically, a model plan (and its imbedded design choices) should be able to move from one financial institution to another almost as seamlessly as an IRA account is currently rolled over from one financial institution to another.

On the other hand, opponents of having the IRS draft model plans believe that many of the problems encountered by the IRS with the model plan documents it developed twenty years ago would still be present today. In particular, opponents are concerned that significant government resources would need to be dedicated to such a project, and there is no reason to believe that model-plan language could be agreed upon by IRS officials, the Chief Counsel’s Office, and other government officials any easier today than in the past.

If anything, the job might be more difficult today because the laws and regulations affecting retirement plans have grown in complexity and length since that time. Moreover, the task of keeping that language up to date in the face of ever-more-frequent changes might be more difficult than ever before.

Moreover, there is no assurance that employers or practitioners would be any more likely to use the model documents today than they were in the past. At the very least, opponents think that the IRS should first survey potential customers for model plans to see if there is sufficient demand to merit the dedication of significant government resources to this project. In short, opponents believe that drafting model plan documents would not be a very productive use of the government’s limited resources.

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<sup>63</sup> See, e.g., *GUST Remedial Amendment Period: Sample Certification of Intent to Adopt a Pre-Approved Plan*, 1 *EMPLOYEE PLAN NEWS* 8 (Summer 2001), available at <http://www.irs.gov/pub/irs-utl/sum01.pdf>.

On the other hand, supporters of having the IRS draft model plans counter that the plans will create their own market: a significant number of plan sponsors will be unwilling to pay for new plan documents each time they move from one third-party administrator or financial institution to another. Supporters also believe that having the IRS draft model plan documents would be a worthwhile use of government resources even if there is not much utilization of those documents. Here, the thinking is that the language developed by the IRS would nevertheless provide valuable examples for those practitioners and institutions drafting their own plan documents. Supporters also believe that having the IRS draft model qualified-plan documents would be a useful exercise that could help the IRS better understand the problems of the practitioners and institutions that it regulates.

In the end, because of the differing opinions, the Project Group recommends only that the TE/GE Division consider whether or not it should develop model qualified-plan documents.

#### 5. Support Loosening of SEP and SIMPLE Minimum Eligibility Rules

SEPs and SIMPLE plans currently are required to cover all employees who satisfy certain minimum eligibility criteria. For example, SEPs are required, at a minimum, to cover all employees who have reached age 21, have worked for the employer in at least 3 of the last 5 years, and have received at least a minimal amount of pay (\$450 in 2002) from the employer for the year. SIMPLE plans are likewise required, at a minimum, to cover all employees who received at least \$5,000 in pay from the employer during any 2 years preceding the current calendar year and who are reasonably expected to receive at least \$5,000 in pay during the current year. An employer can choose to have SEP or SIMPLE plan participation requirements that are less restrictive than the minimum requirements.

Qualified plans are not subject to the minimum eligibility requirements that apply to SEPs and SIMPLE plans. Instead, qualified plans are subject to the minimum participation requirements in I.R.C. §410(a) and the minimum coverage requirements in I.R.C. §410(b). Those requirements are less restrictive than the SEP and SIMPLE minimum-eligibility requirements.

Many small employers have reported that they did not adopt a SEP or SIMPLE plan because the minimum eligibility requirements would require costly contributions for too many employees. If the SEP and SIMPLE minimum-eligibility requirements were loosened, it seems likely that more employers would adopt SEPs and SIMPLE plans.

The Project Group recognizes that only Congress has the authority to amend the Internal Revenue Code to loosen the SEP and SIMPLE plan minimum-eligibility requirements. Nevertheless, the Project Group members recommend that the TE/GE Division look for opportunities to suggest such amendments to Treasury officials involved in determining tax policy.

#### 6. Publicize the Tax Credit for Small Employer Plan Start-Up Costs

Starting in 2002, small employers may be able to claim a tax credit for part of the costs of starting a SEP, SIMPLE, or qualified plan.<sup>64</sup> The credit equals 50% of the cost to set up and administer the plan and educate employees about the plan, up to a maximum of \$500 per year for each of the first 3 years of the plan. The employer can choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective. The employer must have had 100 or fewer employees who received at least \$5,000 in compensation for the preceding year, and at least one participant must be a non-highly compensated employee.

The Project Group recommends that the TE/GE Division make special efforts to have this new tax credit publicized and promoted among the small business community.

#### 7. Publicize the Determination-Letter User-Fee Relief

Starting in 2002, the user fee for requesting a determination letter does not apply to requests by small employers within 5 years after the plan was set up (or by the end of any remedial amendment period that begins within that 5-year period).<sup>65</sup> The employer must have 100 or fewer employees, at least one of whom is a non-highly compensated employee participating in the plan.

The Project Group encourages the TE/GE Division to make special efforts to have the user-fee relief publicized and promoted among the small business community.

#### 8. Publicize the Tax Credit for Elective Deferrals and IRA Contributions

Starting in 2002, certain low- and moderate-income individuals can claim a tax credit of up to \$1,000 for certain qualified retirement savings contributions.<sup>66</sup> The credit is equal to a percentage (50%, 20%, or 10%) of up to \$2,000 of contributions. Encouraging elective deferrals and IRA contributions should result in more employees encouraging their small-business employers to set up retirement plans and payroll-deduction IRA programs.

Consequently, the Project Group recommends that the TE/GE Division make special efforts to promote this new tax credit.

#### 9. Increase Outreach and Partnering Activities

The Project Group also encourages the TE/GE Division to increase its outreach activities and to increase its partnering activities with governmental and private groups interested in promoting retirement savings. For example, the American Savings Education Council (ASEC) is in partnership with the PWBA and with the U.S. Department of the Treasury, Savings Bond Operations Office. The Project Group has

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<sup>64</sup> I.R.C. §45E, added by §619(a) of EGTRRA.

<sup>65</sup> Section 620 of EGTRRA.

<sup>66</sup> I.R.C. §25B, added by §618 of EGTRRA.

already encouraged the TE/GE Division to develop a similar ASEC-IRS partnership and notes that the TE/GE Division is in the process of developing such a partnership.

## B. ENSURING COMPLIANCE WITH RETIREMENT-PLAN RULES

### 1. Develop Employer Plan Compliance Checklists

Small employers need help regarding the basics of setting up and administering retirement plans. In that regard, Recommendation V.A.2, above, called upon the TE/GE Division to develop an employer “how-to” manual.

In addition to such a manual (or as part of such a manual), the TE/GE Division should provide compliance-oriented checklists and plain-language explanations to assist small employers.<sup>67</sup> Even employers that do not administer their own plans are generally responsible for the sufficiency and accuracy of the services they receive from third-party administrators. Such checklists could be provided to employers as part of Form 5500 packages. The Project Group believes that such checklists would be valuable to the small business community and its representatives, whether or not the TE/GE develops a full “how-to” manual.

### 2. Obtain and Use Lists of M&P and Volume-Submitter Adopters

The TE/GE Division currently requires sponsors of M&P plans and volume-submitter plans to maintain lists of adopting employers but does not require such lists to be provided to the TE/GE Division. The Project Group recommends that the TE/GE Division consider obtaining such lists, either uniformly (from all such sponsors) or selectively (from sponsors chosen for compliance activities). The TE/GE Division should consider beginning with a research project that provides information about the compliance levels of adopters of M&P plans and volume-submitter plans.

Obtaining such lists could help the TE/GE Division identify Form-5500 nonfilers, especially if the lists were matched against the plans that do file Forms 5500 and identify themselves (using codes 3D or 3E in item 8a of Form 5500) as having been adopted under master or prototype plans. Obtaining such lists could also help the TE/GE Division fill gaps in its knowledge base regarding the numbers of total qualified plans and be another source of information from which to develop plan-examination programs. And because most employers adopting M&P plans or volume-submitter plans are “word-for-word” adopters that can rely on the opinion letters or approval letters issued to the M&P or volume-submitter plan sponsors and are thus unlikely to apply for determination letters, obtaining such lists could help the TE/GE Division better estimate the number of qualified plans that it could expect to apply for determination letters in the future.

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<sup>67</sup> See, e.g., CIGNA Retirement and Investment Services, *Compliance Checklist 2002: An Easy-to-Follow Guide to Government Reporting and Disclosure Requirements (CIGNA's Pension Analyst, Special Edition 2002)*, available at <http://www.cigna.com/professional/pdf/Cklt02basic.pdf>.

### 3. Encourage Plan Operation Manuals

The TE/GE Division should encourage third party vendors and plan sponsors to develop plan operation manuals for each plan. Each plan's operation manual should set forth the various requirements for maintaining the plan's operational compliance and identify the persons responsible for satisfying those requirements. For example, the plan operational manual should indicate what records the plan is to maintain and who has the responsibility for maintaining those records. Similarly, for a plan that is required to conduct nondiscrimination testing, the plan operation manual should indicate when and how to conduct that test, who is responsible for conducting the test, and how the results are to be recorded.

The Project Group believes that plan operation manuals could significantly improve operational compliance in the small business sector. The Project Group notes that the TE/GE Division's voluntary compliance correction programs (*i.e.*, Employee Plans Compliance Resolution System [EPCRS]) already require plans to have established practices and procedures.<sup>68</sup> The Project Group encourages the TE/GE Division to find additional ways to get plan operation manuals to be developed and used. Perhaps the TE/GE Division should require such manuals as a prerequisite to pre-approval of M&P and volume-submitter plans.

### 4. Condition Form 5500-EZ Filing Waiver on Initial Registration

The TE/GE Division has incomplete knowledge of the existence of one-participant plans which (if they have less than \$100,000 of assets) are not required to file even Form 5500-EZ. The knowledge gap diminishes the ability of the TE/GE Division to understand the size of its qualified-plan "market" and to "match" plans with all the employers that obtain tax advantages by deducting plan contributions. (Although other divisions of the Internal Revenue Service concern themselves with the deductibility of retirement-plan contributions, only the TE/GE Division focuses on retirement-plan qualification, which is a prerequisite for the deductibility of contributions.) The knowledge gap also virtually eliminates the already-minimal likelihood that one-participant plans will be the subject of TE/GE Division examination efforts.

The Project Group considered recommending that the TE/GE Division require all one-participant plans to file returns. Instead, to balance the filing-cost-to-the-employer with the knowledge-benefit-to-the-government, the Project Group recommends that the TE/GE Division merely require a one-time filing (such as a registration-statement) by each one-participant plan that wishes to avoid filing an annual Form 5500-EZ. Even such one-time filings should be unnecessary if, as set forth in Recommendation V.B.2 above, the TE/GE Division were to obtain lists of M&P and volume-submitter adopters, because such lists would include the vast majority of one-participant-plan adopters.

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<sup>68</sup> *Revenue Procedure 2001-17, 2001-7 INTERNAL REVENUE BULLETIN 589, at 594.*



## 5. Expand Form 5500 to Require Certification of Operational Compliance

Compliance with complicated and confusing tax laws is difficult at best. An improper allocation or an improperly performed test can have far-reaching effects on participants. Inadequate attention to qualification requirements in the operation of the plan can seriously undermine the protections afforded to participants and beneficiaries under the law.

The Project Group believes that operational compliance would be improved if Form 5500 were amended to include a plan-administrator certification that the plan was operated in compliance with applicable tax-qualification and ERISA rules. The Project Group recognizes that plan-administrator certifications would cover many of the same matters as compliance checklists (described in Recommendation V.B.1.) and plan operation manuals (described in Recommendation V.B.3.). Therefore, the TE/GE Division should consider the relative burdens and benefits of these various alternatives before deciding which alternative (or alternatives) should be pursued.

The Project Group also recognizes that a certification might sometimes increase the cost of plan administration (and might other times constitute little more than a self-serving statement by the administrator). Therefore, the Project Group recommends that the TE/GE Division consider applying such a certification-requirement only to large plans, initially, and later (after administrators become familiar with the requirement) to small plans. The TE/GE Division should also consider whether a certification requirement should be limited to certain plan types, certain industries, or certain issues.

The Project Group notes that the Form 5500 for a qualified plan is usually prepared by an administrator (either the employer or an independent third-party administrator) who has (or should have) thorough knowledge of the plan's compliance or non-compliance with the many rules that apply to the operation of the plan. For the most part, however, the Form 5500 currently solicits little information about the plan's actual compliance with operational rules, rules which (if not self-enforced) are left up to IRS examiners to enforce.<sup>69</sup> For example, the Form 5500 does not ask whether a 401(k) plan satisfies the actual deferral percentage (ADP) test of I.R.C. §401(k)(3).

To be most useful, a compliance certificate would cover not just tax-qualification matters but also ERISA Title I matters. Therefore, it would be developed not just by the TE/GE Division but also by the Department of Labor. The certificate could indicate that:

- The plan has been operated in accordance with its terms;
- All numerical nondiscrimination and coverage tests have been satisfied; and
- There is no reasonably apparent basis for concluding that:
  - the plan has lost its qualified status;
  - unreported prohibited transactions have occurred; or
  - there are uncorrected breaches of fiduciary responsibility.

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<sup>69</sup> *Form 5500, Schedule T, Qualified Pension Plan Coverage Information, does require some compliance certification with respect to the coverage rules of I.R.C. §410(b).*

For example, the certificate for a 401(k) plan could state that the plan has met, *inter alia*, the following qualification requirements during the year:

- The coverage tests under I.R.C. §410(b);
- The elective deferral limits as provided in I.R.C. §§402(g) and 414(v);
- The I.R.C. §401(k)(2) distribution rules; and
- The actual deferral percentage test of I.R.C. §401(k)(3).<sup>70</sup>

Such a certificate, especially if it is in the form of a checklist, could help small employers identify the kinds of operational rules that most often need attention for a plan to remain in compliance. The certification could encourage (and perhaps point directly to) the established practices and procedures that plans should have (as referenced in the Employee Plans Compliance Resolution System [EPCRS]).

Some persons outside of the IRS have recommended the establishment of “Certified Compliance Specialists” who would oversee retirement-plan operational compliance and execute such certificates. These Certified Compliance Specialists would be analogous to enrolled actuaries, who make representations as to actuarial matters and execute the Form 5500, Schedule B. For pension professionals to become Certified Compliance Specialists, they would have to complete a program of education and testing. An organization (similar to the Joint Board for the Enrollment of Actuaries) would presumably be established to oversee and maintain a list of qualified specialists.

The Project Group is sympathetic to the Certified Compliance Specialist concept but recognizes that, for reasons of cost and politics, the concept is unlikely to become reality. Therefore, the Project Group would be satisfied to have plan operational compliance certified by administrators, including employers themselves, who have not undergone any particular program of education or testing.

#### 6. Consider Including Retirement-Plan Information on Employer Tax Returns

Employer income-tax returns that report retirement-plan contribution deductions currently do not provide any information regarding the plan or plans to which the contributions are made. Likewise, the Form 5500 currently does not require any reconciliation with the amount of the deduction (or any reporting of the I.R.C. §404 limit on the amount of the deduction). Complicating matters are the jurisdictional lines between the TE/GE Division, which focuses on plan-qualification matters (not deductions), and other Internal Revenue Service divisions, which focus on the deductions (not plan qualification) as part of the determination of income-tax liability. (This jurisdictional gap is mirrored in the employer arena, in which income-tax-return preparers often lack knowledge about plan-qualification matters and retirement-plan administrators often lack knowledge about tax-return deduction matters and, without

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<sup>70</sup> See, e.g., INTERNAL REVENUE MANUAL Handbook section 7.7.1 (Employee Plans Examination Guidelines), subsection 2.2 (Qualified CODA Requirements).

sufficient communication between the two, employers have sometimes been unintentionally allowed to exceed the I.R.C. §404 deduction limits for years in a row.) Yet the deductions are premised upon the tax qualification of the plans.

The Project Group believes that an annual-reporting linkage should be made between the deductions and the retirement plans. An appropriate linkage might be to have the income-tax returns include basic information regarding the plans to which the contributions are made. Such a linkage could facilitate the identification of appropriate examination targets by the TE/GE Division and enable the TE/GE Division to “match” employers with their retirement plans and better identify Form 5500 nonfilers.

The Project Group recommends that the TE/GE Division explore, with other affected Internal Revenue Service divisions, the idea of having employer income-tax returns include information regarding the plans to which the contributions are made. Such information could be limited to basic matters such as (1) a calculation confirming that the deduction limit was not exceeded (taking into account any differences between plan years and employer taxable years) or (2) a schedule of the retirement plans (and their types) to which contributions are being reported or (3) a statement as to whether Forms 5500 were filed for the most recent plan year (and, if not filed, confirmation that they were not required).

The employer income-tax return requirements could go much farther, of course, and even include an employer’s certification (executed with regard to a plan-compliance checklist set forth in the tax-return instructions) that its plans comply with all applicable qualification rules. Such a certification could be in lieu of the certification described in Recommendation V.B.5.

The Project Group recognizes that the TE/GE Division might encounter difficulties with the idea of adding more reporting requirements to employer income tax returns. An easier-to-achieve goal might be to add a deduction-oriented reporting requirement to the Form 5500 and sharing the reported information with the other divisions of the Internal Revenue Service. Either way, the TE/GE Division should explore these ideas with the Internal Revenue Service divisions that examine employer income-tax returns.

## 7. Conduct Regular Compliance Surveys

As noted above, the TE/GE Division has completed a survey of compliance problems with 401(k) plans.<sup>71</sup> TE/GE Division management has indicated that it agrees with the U.S. General Accounting Office regarding the need to improve the quality and usefulness of future such surveys.<sup>72</sup>

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<sup>71</sup> *COMPLIANCE PROFILE OF SECTION 401(k) PLANS: RESULTS OF AN IRS SURVEY, supra note 4.*

<sup>72</sup> *U.S. GENERAL ACCOUNTING OFFICE, PRIVATE PENSIONS: IRS CAN IMPROVE THE QUALITY AND USEFULNESS OF COMPLIANCE STUDIES, supra note 4.*

The Project Group strongly encourages the TE/GE Division to continue developing a system of regular and periodic surveys of the compliance problems of various Employee Plans customers of the TE/GE Division. The Project Group also encourages the TE/GE Division to publish its compliance survey findings and, where possible, to make the underlying data available to academic and other nongovernmental researchers.

8. Improve Assessments of Which Plans Need Examination and Education

The Project Group has been informed that the TE/GE Division is developing new research samples for qualified plans, nonfilers, SEP adopters, and third-party administrators. In particular, the TE/GE Division is developing data-driven methods of assessing the risk and reliability of retirement-plan compliance levels by employers in various industry groups, so that the TE/GE Division can better target its customer education/outreach activities and plan examinations toward employer groups that have shown more significant compliance problems. The TE/GE Division is also considering whether limited-scope examinations would be a useful way to focus on particular compliance problems in a broad group of plans. The Project Group applauds such approaches as enabling the TE/GE Division to direct its limited resources where they are most needed and most effective.

9. Develop a Public-Use Database

Research by academics and other nongovernmental researchers can help improve a public/private understanding of retirement plan compliance and noncompliance. In that regard, the U.S. Department of Labor regularly publishes abstracts of Form 5500 Annual Reports.<sup>73</sup> The Project Group encourages the TE/GE Division to develop similar public-use databases with respect to determination letters, examinations, voluntary-compliance cases, IRAs, SEPs, SIMPLEs, and qualified plans. Of course, such databases would be permitted to contain no taxpayer-specific or other confidential information.

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<sup>73</sup> See, e.g., *Abstract of 1996 Form 5500 Annual Reports*, *supra* note 23.