

---

# Advisory Committee on Tax Exempt and Government Entities (ACT)

---

## Report of Recommendations





**Advisory Committee on Tax Exempt and Government Entities (ACT)  
Public Meeting  
1111 Constitution Ave., NW.  
Room 3313  
Washington, D.C., 20224**

**June 13, 2007**

**Meeting Begins at 9:00 a.m.**

**AGENDA**

Meet and Greet (8:30 a.m. – 9:00 a.m.)

Welcome and Opening Remarks

- Kevin M. Brown, Acting Commissioner, Internal Revenue Service
- Steven T. Miller, Commissioner, Tax Exempt and Government Entities
- Steven J. Pyrek, Designated Federal Official of the ACT
- Charles F. Plenge, Chair of the ACT

***Review of Voluntary Self-Compliance Program for Indian Tribal Governments***

Lenor A. Scheffler

***A Proposal for an Exempt Organizations Voluntary Compliance Program***

Sean Delany

***After the Bonds Are Issued: What Then?***

Maxwell D. Solet

***Improving Compliance for Adopters of Pre-Approved Plans***

Charles M. Lax

***A Prototype for Public Sector Defined Contribution Plans***

Julian Regan

***Public Employers' Withholding and Reporting for Non-Resident Aliens***

Steven W. Hoffman

Closeout



**ADVISORY COMMITTEE  
ON TAX EXEMPT AND GOVERNMENT ENTITIES**

**2006-2007**

**Member Biographies**

**EMPLOYEE PLANS**

- **Susan D. Diehl**, Horsham, PA

Ms. Diehl is the president of PenServ Inc., a nationally recognized pension consulting firm providing services to more than 800 financial organizations on sponsoring retirement plans. A major part of her activities and products involves educating individuals and practitioners on the whole range of retirement plans — including IRAs, Qualified Plans, 403(b) and 457 plans, and Nonqualified Deferred Compensation Plans. Ms. Diehl has a Bachelor of Arts in mathematics from Arcadia University in Pennsylvania.

- **Dodi Walker Gross**, Pittsburgh, PA

Ms. Gross is an employee benefits lawyer and partner with Reed Smith LLP, one of the 10 largest law firms in the United States. In this capacity, she represents local, national and multinational corporations with operations in the United States, Puerto Rico, Canada, Germany, United Kingdom and other countries. Her work encompasses the full range of employee benefits matters with respect to retirement, savings and welfare plans. It also involves executive compensation — including design, administration, compliance, dispute resolution, government audits, and corporate and employment transactions. Ms. Gross has a Juris Doctor from Duquesne University School of Law.

- **Charles M. Lax**, Southfield, MI

Mr. Lax is a partner and chairman of the Employee Benefits Group at his law firm, Maddin, Hauser, Wartell, Roth & Heller, P.C. His responsibility includes the representation of approximately 350 qualified retirement plans of all types and sizes. He authored numerous articles appearing in legal and public accounting journals and lectured extensively on qualified retirement plans and other tax topics. Mr. Lax received his Juris Doctor from the University of Michigan. He presently serves as the Chairman of the Tax Section of the State Bar of Michigan.

- **Charles F. Plenge**, Dallas, TX

Mr. Plenge is a partner in Hayes and Boone, LLP and is Chair of its Employee Benefits/Executive Compensation Practice Group. His practice primarily involves a broad range of employee benefits and executive compensation matters on behalf of employers. Mr. Plenge is a Charter Fellow of the American College of Employee Benefits Counsel and holds his Juris Doctor in Law from Southern Methodist University Dedman School of Law.

- **Daniel J. Schwartz**, St. Louis, MO

Mr. Schwartz is a shareholder in the St. Louis law firm of Greensfelder, Hemker & Gale, P.C. His practice encompasses all aspects of employee benefits and executive compensation law, with a special emphasis on employee benefits issues for tax-exempt organizations. Mr. Schwartz is a Charter Fellow of the American College of Employee Benefits Counsel. He received his JD from the University of Missouri-Kansas City.

- **Michael S. Sirkin**, New York, NY

Mr. Sirkin is a senior partner in the Employee Benefits and Executive Compensation Group in his firm, Proskauer Rose LLP. He has practiced in the employee benefits area since 1972 and has been heavily involved with all aspects of employee benefits, including extensive experience in qualified plans, 403(b) plans and nonqualified plans. Mr. Sirkin is a graduate of Columbia Law School.

## **EXEMPT ORGANIZATIONS**

- **Betsy Buchalter Adler**, San Francisco, CA

Ms. Adler is a member of the law firm of Silk, Adler and Colvin, which specializes in the law of nonprofit and tax-exempt organizations. In that capacity she provides legal advice and counsel to grant-making charities, operating charities, educational and religious institutions, trade associations, and individual and corporate philanthropists. She is the immediate past chair of the Exempt Organizations Committee of the Tax Section of the American Bar Association and a well-known author and lecturer in the tax-exempt field. She received her B.A. from the University of California at Santa Cruz and her J.D. from Boalt Hall School of Law, University of California at Berkeley.

- **Bonnie Brier**, Philadelphia, PA

Ms. Brier is the general counsel of The Children's Hospital of Philadelphia. In her 25 years of practice in the field of exempt organizations, she has specialized in the area of health care, compensation and benefits, and charitable giving. Ms. Brier has a Juris Doctor from Stanford University

- **Sean Delany**, New York, NY

Mr. Delany is the Executive Director of Lawyers Alliance for New York, Inc., an organization that provides non-litigation legal assistance to nonprofits and community development organizations in New York City. His organization provides services dedicated to improving the accountability and efficiency of small tax-exempt organizations, and includes counseling on their ongoing compliance with federal and state regulatory obligations. He has also served as Assistant Attorney General in Charge of the Charities Bureau in the New York Attorney General's office.

- **Julie L. Floch**, New York, NY

Ms. Floch is the Director of Not-for-Profit Services at Eisner LLP, and is the partner responsible for coordinating the planning and administration of engagements in the firm's not-for-profit practice. She is an adjunct professor of auditing at Baruch College/CUNY and teaches not-for-profit management at the New School University. A graduate of the State University of New York at Binghamton, with graduate studies at Baruch College/CUNY, Ms. Floch serves on the influential Not-for-Profit Organizations Expert Panel of the American Institute of CPAs and is currently a member of the New York State Society of CPAs' committee on not-for-profit organizations (which she formerly chaired) and its committee on tax-exempt entities.

- **Suzanne Ross McDowell**, Washington, DC

Ms. McDowell is a partner at the law firm of Steptoe & Johnson LLP, where her practice focuses primarily on tax-exempt organizations. She has over 20 years experience working with nonprofit organizations. Prior to joining Steptoe & Johnson in September 2002, she was Senior Vice President and Deputy General Counsel at the National Geographic Society, Washington, DC. She also served as Associate Tax Legislative Counsel at the U.S. Department of the Treasury in the mid-1980s, and has prior private practice experience. She is active in the Tax Section of the D.C. Bar, the American Bar Association, and the American Society of Association Executives. She received her A.B. from Smith College and her J.D., *magna cum laude*, from the George Washington University National Law Center.

- **Ana Thompson**, San Mateo, CA

Ms. Thompson is the managing director of finance and administration for the Charles and Helen Schwab Foundation, where she is responsible for leadership of the foundation, grant-making, oversight of short- and long-term financial planning, and regulatory compliance. Ms. Thompson has a Masters of Business Administration from the Stanford Graduate School of Business.

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

- **Steven W. Hoffman**, Columbus, OH

Mr. Hoffman is the tax manager for The Ohio State University, where he is responsible for issues concerning taxation in state and local governments and tax-exempt entities. His background includes 15 years with the IRS and with OSU's tax-exempt bond activity. Hoffman, an enrolled agent and a certified financial planner, has a Master of Science in Taxation from Capital University in Ohio.

- **Nicholas C. Merrill, Jr.**, Springfield, IL

Mr. Merrill is the manager of the accounting division for the State Employees' Retirement System of Illinois, a large statewide Public Employees' Retirement System. He is a certified public accountant and previously worked for a national public accounting firm where he specialized in governmental audits. He has served as President of the National Conference of State Social Security Administrators (NCSSSA), as well as in other roles within that organization. He is also active in the Government Finance Officers Association.

- **Julian Regan**, Marlborough, MA

Until April 2006, Mr. Regan was Executive Director of the New York State Deferred Compensation Board, which oversees the State's 159,000-member, \$7.1 billion Deferred Compensation Plan and performs State regulatory duties that relate to 250 independently operated section 457 plans. He served for a number of years in the financial operations arena of the Massachusetts Bay Transportation Authority as well as in operations and audit capacities for private sector firms that specialize in delivering services to large Tax-Exempt Entities. He is a member of the New York State Government Finance Officers Association (NYSGFOA). Mr. Regan is now a Vice President for Fidelity Employer Services Company, where he works primarily with institutional retirement and employee benefits business units.

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

- **Lenor A. Scheffler**, Minneapolis, MN

Ms. Scheffler, a partner with Best & Flanagan, heads the firm's Native American Law Practice Group which represents a number of Indian tribes on tax, finance, business, and government matters. She has previously served as General Counsel and as Vice President of Corporate and Legal Affairs for tribes in Minnesota. She is currently the Chief Judge of the Upper Sioux Community Tribal Court. Ms. Scheffler received her Juris Doctor from the William Mitchell College of Law.

- **Sandra Starnes**, Kingston, WA

Ms. Starnes is a certified public accountant who works as the cash management officer for the Port Gamble S'Klallam Tribe in the state of Washington. Her experience includes working with non-profit organizations. Ms. Starnes has a Bachelor of Arts in accounting and business administration.

- **Mary J. Streitz**, Minneapolis, MN

Ms. Streitz is a partner in the law firm of Dorsey & Whitney LLP, with wide experience in a wide variety of tax issues affecting Indian tribal governments and other tribal entities. She has represented tribes in all regions of the country. She also heads up her firm's national Indian tax practice. Ms. Streitz has a Juris Doctor from the New York University School of Law.

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

- **Joan M. DiMarco**, Philadelphia, PA

Ms. DiMarco is the managing partner of the Philadelphia office of BondResources Partners LP. Her background includes a wide range of experience in consulting to investment bankers, law firms, issuers and governmental agencies. She has more than 30 years of experience in municipal bonds and structured finance. Ms. DiMarco is a certified public accountant and has a Bachelor of Science in business administration from Drexel University.

- **Robert E. Donovan**, Providence, RI

Mr. Donovan is Executive Director of the Rhode Island Health and Educational Building Corporation. He is responsible for the operation of the state designated issuer of tax-exempt bond debt on behalf of private non-profit health care and educational institutions. He also serves on a number of boards and committees relating to tax-exempt bonds. Mr. Donovan holds a Certificate of Advance Graduate Studies in Finance, as well as an MBA from Bryant College.

- **Maxwell D. Solet**, Boston, MA

Mr. Solet is a member of the law firm of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C., where he has principal tax responsibility in connection with the firm's role as bond counsel, underwriter's counsel and purchaser's counsel on state or local bond issues. These include bonds of large general obligation issuers, specialized revenue bond issuers, housing finance agencies, student loan agencies, and conduit issuers of bonds to finance healthcare and education facilities and solid waste disposal facilities. He is a former chair of the Tax Section of the Boston Bar Association and is a member of the steering committee of the annual Bond Attorneys Workshop. Mr. Solet received a Bachelor's degree from Harvard College and a Juris Doctor degree from Harvard Law School.

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

This is the sixth public meeting of the Advisory Committee on Tax Exempt and Government Entities (the "ACT"). The ACT members appreciate the opportunity to report to the Internal Revenue Service and the public regarding the interaction of the Tax Exempt and Government Entities Division of the Internal Revenue Service ("TE/GE") and its stakeholders, including employee retirement plans, charities and other tax exempt organizations, tax-exempt bond issuers, and federal, state, local and Indian tribal government entities. This year several of the reports address the issue of voluntary compliance, which is designed to enable stakeholders to address and correct non-compliance, and other reports address the need for additional outreach and resources to enable stakeholders to comply with the often-times complex requirements associated with the maintenance of their tax-exempt status. As former Commissioner Everson and Acting Commissioner Brown have noted repeatedly, enforcement of the relevant tax laws cannot be achieved through the audit function alone. The ACT hopes its recommendations in this year's reports will assist the IRS in furthering the achievement of proper compliance.

The six reports the ACT is presenting this year are as follows:

## **Indian Tribal Governments: Review of Voluntary Self-Compliance Program for Indian Tribal Governments**

In December 2005, the IRS Office of Indian Tribal Governments ("ITG") established a voluntary self-compliance program which affords Tribal Governments the opportunity to perform their own IRS compliance checks. The program has not received much interest by Tribal Governments, and ITG asked the ACT to evaluate the reasons for the lack of Tribal participation in the Program and to make recommendations for increasing participation. This ACT report includes, among others, recommendations to improve communication, enhance promotion of the internal use of the self-compliance form, compartmentalize the Program by tax issues, and create Compliance Check Toolkits.

## **Exempt Organizations: Proposal for an Exempt Organizations Voluntary Compliance Program**

In the U.S. there are some 1.6 million exempt organizations which control more than \$2.4 trillion in assets. Exempt organizations, like taxable enterprises, sometimes discover that they are out of compliance with the tax law and wish to correct the problem themselves, rather than waiting for enforcement attention from the IRS. However, exempt organizations currently have no formal self-correction program of

general applicability. This ACT report recommends the creation of a broad-based, formal, and continuing voluntary compliance program similar, where appropriate, to the voluntary correction programs established by other Divisions of TE/GE.

### **Tax-Exempt Bonds: After the Bonds Are Issued: Then What?**

Many governmental issuers of tax-exempt bonds and private, nongovernmental conduit borrowers are not adequately prepared to monitor ongoing compliance with federal law affecting those bonds. There is particular concern for newly-elected or appointed officials who might have little prior experience with tax-exempt debt. This ACT report presents an informational paper on post-issuance compliance in a format appropriate for inclusion in the "Information for the Tax Exempt Bond Community" section of the IRS Web site. The informational paper presented in this report is designed to be at a level of generality suitable for elected or appointed officials, and to identify areas requiring compliance procedures without attempting to ask and answer all possible questions.

### **Employee Plans: Improving Compliance for Adopters of Pre-approved Plans**

Currently, the IRS estimates that at least 94% of all qualified retirement plans are Master and Prototype plans and Volume Submitter plans. This report arose from the ACT's belief that there is a need to provide compliance assistance to employers who have adopted these plans, since many of those employers are neither equipped to comply nor willing to pay for compliance with the complex requirements for tax-qualified retirement plans. This ACT report contains a series of recommendations designed to provide employers adopting these plans with material designed to inform them of the legal requirements associated with maintaining these plans. These recommendations include, among others, the distribution of a form which advises adopting employers of the responsibilities associated with these plans and includes a list of the parties responsible for performing various administrative functions on behalf of the plan; and the provision of additional education, outreach and guidance to these employers regarding the compliance requirements for these plans.

### **Federal, State and Local Governments: A Prototype for Public Sector Defined Contribution Plans**

The ACT perceives a need to further improve operational and plan document compliance for Code Section 401(a) defined contribution plans adopted by government entities. This project will span two years, with the final report being delivered in June 2008. This year's Act report will provide anecdotal evidence of compliance challenges, along with preliminary findings and a plan for possible recommendations, which might include the adoption of a prototype system for government 401(a) plans similar to the system currently available to corporate 401(k) plans, and recommended educational content tailored to the needs of government 401(a) plan practitioners and sponsors. The educational information could be included or referenced in the Federal, State and Local Government (FSLG) Toolkit that is included in the FSLG section of the Government Entity Division's web site.

## **Federal, State and Local Governments: Public Employers' Withholding and Reporting for Non-Resident Alien Taxation**

The US Census Bureau reported in March, 2002 that there were 87,525 state and local government employers, employing 18,349,000 workers, with payrolls amounting to 525,235 million dollars. It has been estimated that 20% of the American workforce is now employed by federal, state, or local government entities. Prior ACT reports have noted that public employers have long promoted voluntary compliance as the key to effective and efficient tax administration. Voluntary compliance by public employers requires not only executing specific withholding and reporting functions, but also identifying and eliminating barriers which prevent voluntary compliance. This ACT report contains recommendations to enhance the "Toolkit" on the IRS website to assist government payroll officers in determining the correct amount of withholding and the reporting requirements for non-resident aliens, and to increase contact with the public sector employment community through informational seminars and targeted mailings.

Having completed its fifth year June 2007, the ACT this year undertook with the TE/GE leadership an evaluation of its mission and its current advisory role in an effort to determine whether its activities and reports were consistent with the underlying purpose for its establishment – namely to provide an organized public forum for discussion of relevant issues between officials within TE/GE and representatives of the appropriate stakeholder communities; and to enable the IRS to receive regular input with respect to the development and implementation of tax administration issues affecting those communities. As part of this evaluation, separate meetings were held between the appropriate TE/GE officials and the various stakeholder groups represented by the ACT membership. The ACT and the TE/GE leadership concluded after this evaluation that the ACT's mission as originally envisioned was still appropriate, and that the ACT and TE/GE would continue to engage in the introspective dialogue established this year in order to ensure that both groups were engaged in the sort of interaction envisioned when the ACT was established.

Since service on the ACT carries a maximum term of three years, the following members are completing their term this year:

- Robert E. Donovan, Rhode Island Health and Educational Building Corp., Providence, RI
- Julie Floch, Eisner LLP, New York, NY
- Charles M. Lax, Maddin, Hauser, Wartell, Roth & Heller, P.C., Southfield, MI
- Suzanne Ross McDowell, Steptoe & Johnson LLP, Washington, DC
- Charles F. Plenge, Haynes and Boone, LLP, Dallas, TX
- Lenor A. Scheffler, Best and Flanagan LLP, Minneapolis, MN

The ACT thanks them for their service and dedication throughout their term.

The ACT also would like to express its sincere appreciation and thanks to the TE/GE personnel with whom it has worked this year. In particular, we would like to thank former Commissioner Mark W. Everson and Acting Commissioner Kevin M. Brown for their interest in the ACT and its activities. We also would like to thank TE/GE Commissioner Steven T. Miller, Deputy Commissioner Christopher Wagner and the current directors, Joseph Grant, Michael Julianelle and Lois Lerner, as well as Christie Jacobs, Cliff Gannett, Sunita Lough and the other IRS staff and former staff for their valuable time and responsiveness as we undertook our evaluations and the preparation of our reports.

The ACT would especially like to thank Steven Pyrek, the ACT's Designated Federal Official, without whom none of us could have functioned as effortlessly and efficiently during and between our meetings in Washington, D.C. His management and organizational skills are only surpassed by his willingness to provide whatever assistance we needed.

The ACT's success depends not only on the hard work and dedication of its members, but on the cooperation and willingness of the TE/GE personnel to provide the time and information the ACT requests. The friendliness and professionalism shown by all of the TE/GE personnel is appreciated by the ACT, and is the main reason for the ACT's continued ability to fulfill its mission.

Charles F. Plenge  
Chairman

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

**REVIEW OF VOLUNTARY SELF-COMPLIANCE PROGRAM FOR  
INDIAN TRIBAL GOVERNMENTS**

**Lenor A. Scheffler, Project Leader  
Sandra Starnes  
Mary J. Streitz**

**JUNE 13, 2007**

This page left intentionally blank

**TABLE OF CONTENTS**

I. EXECUTIVE SUMMARY.....5

II. PROJECT PROCESS .....6

III. DISCUSSION .....7

    A. Unique Challenges in Establishing a Voluntary Self-Compliance Program for Tribal Governments .....7

    B. Development, Implementation, and Use of the Current Program .....8

    C. Feedback Obtained Regarding the Program .....10

IV. RECOMMENDATIONS .....13

V. CONCLUSION .....18

APPENDIX .....

    EXHIBIT A: Survey Forms and Cover Letters .....

    EXHIBIT B: Form 13797 .....

    EXHIBIT C: Explanatory Material from IRS Website .....

    EXHIBIT D: Current ITG Compliance Check Letter .....

    EXHIBIT E: Suggested Revised ITG Compliance Check Letter .....

Review of Voluntary Self Compliance Program for Indian Tribal Governments

## I. EXECUTIVE SUMMARY

There are over 560 federally recognized Indian Tribes in the United States. Each Tribe has its own unique government, culture, language, values, and tribal policy goals. Resources available to Tribes vary considerably and relatively few Tribes have sufficient resources to afford expert staff and counsel regarding tax matters. The Tribal Governments and entities created by them, their tribal members, tribal government staff, financial officers, internal and external accountants, and internal and external lawyers who work with them are the customers of the IRS Office of Indian Tribal Governments (“ITG”).

The Federal Government maintains a government-to-government relationship with Tribes and ITG has recognized the importance of tribal sovereignty by the establishment of a voluntary self-compliance program in December 2005. This program affords Tribal Governments the opportunity to perform their own IRS compliance checks. The voluntary self-compliance program is due both to ITG’s recognition of tribal sovereignty, and to the personal efforts of key ITG staff. The name given to the program by ITG is “Tribal Evaluation of Filing and Accuracy Compliance,” shortened to the acronym “TEFAC.” We will refer to the program in this report as the “Voluntary Self-Compliance Program” or the “Program.”

While the creation of the Voluntary Self-Compliance Program has been a significant step forward in recognizing Tribal sovereignty, it has not received much interest by Tribal Governments. This report was solicited by ITG, which asked the ACT to evaluate the reasons for the lack of Tribal participation in the Program and to make recommendations for increasing this participation.

During this project the ACT Committee gathered and reviewed information available from ITG staff, surveyed Tribal Governments and their professional advisors, and had a select group of Tribal employees complete the voluntary self compliance form without submission to the IRS. We will discuss in detail the process we used, the development of the program and our survey feedback in the following order:

- Part II : Methodology in preparing this report.
- Part III(A): Unique challenges for the IRS in establishing a Tribal voluntary self-compliance program
- Part III(B): Development, implementation, and use of the current Program.
- Part III(C): Feedback we received regarding the Program, primarily from the survey

Our recommendations, discussed in more detail below, are as follows:

- Improve communication
  - Improve relationship with important regional Tribal groups
  - Adjust protocols used in ITG’s Consultation Listening Meetings
  - Revise ITG’s form letter used to initiate a compliance check
  - Provide more focused outreach and education
- Enhance promotion of internal use of Form 13797, the self-compliance form
- Compartmentalize the program by tax issues
- Create Compliance Check Toolkits
- Eliminate open-ended questions from Form 13797

- Rename the program
- Be patient

## II. PROJECT PROCESS

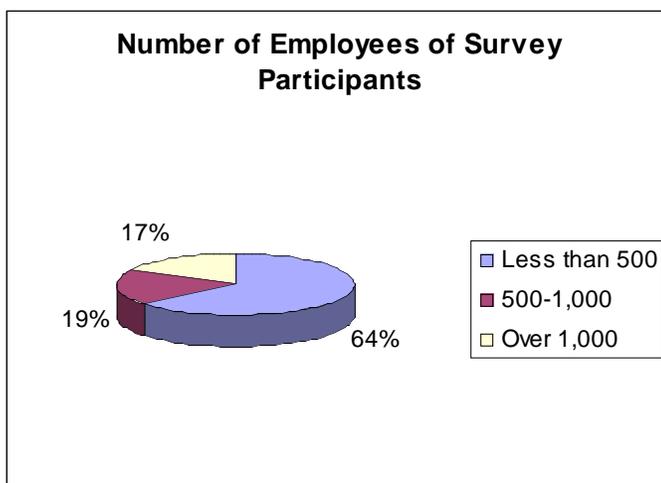
The Project Group began by gathering and reviewing information available from ITG staff regarding the Program.

ITG staff informed us about the history of the Voluntary Self-Compliance Program and how it is working to date. We reviewed all material posted on ITG's website relating to the Voluntary Self-Compliance Program and requested information regarding how many individuals went to the website and looked at the information provided on the Program.

We obtained from ITG staff a general overview of ITG's compliance check and examination programs to determine the relationship between the Voluntary Self-Compliance Program and these other programs.

We conducted a written survey of Tribal Governments and professional advisors to determine how many Tribal Governments were aware of the program and obtain other feedback regarding the Program; all participants in the survey were afforded the opportunity to remain anonymous. A copy of the survey forms and accompanying cover letters are attached as Exhibit A.

To ensure we received responses from a broad range of Tribes, we asked each respondent to identify the number of Tribal employees. Below is a chart showing the make up of the survey participants:



The responding Tribes conduct a broad range of activities to raise revenues for government operations and programs, using a variety of governmental and enterprise structures. Twelve of the 39 responding Tribes conduct gaming, and 11 or more of the 39 responding Tribes conduct retail sales. Other revenue raising activities represented include land leasing, housing, natural resources, wholesale sales, recreational facilities, telecommunications, and taxation.

Although the surveys were not “scientific,” we sought to reach as many Tribal Governments as possible. We mailed surveys to 377 leaders of each of the federally recognized Tribal Governments in the lower 48 states,<sup>1</sup> as well as to approximately 147 other Tribal Government employees and 21 Tribal Government professional advisors known to the members of the Project Group representing a broad cross section of Tribal Governments across the country. We received 39 responses to the survey of Tribal Governments and one response to the survey of professional advisors. The response rate from the Tribal Governments appears to be over 10 percent and to represent a broad cross section of Tribal Governments across the country.

We spoke with an attorney for the United Southern and Eastern Tribes (“USET”), an association of 26 Tribal Governments that facilitated the “pilot” phase of the Program. This attorney provided us with feedback regarding the experience of the pilot phase Tribes, as well as his views regarding the benefits for Tribal Governments of participating in the Program.

We reviewed the current Voluntary Self-Compliance Program Form 13797, the explanatory material regarding the Program posted on the IRS website, and the current form letter sent by ITG to Tribal Governments informing them of the Program, copies of which are attached as Exhibits B, C, and D, respectively.

We then asked a few Tribal employees to undertake the exercise of completing the Voluntary Self-Compliance Form without submitting the completed Form to ITG, so that we could get additional feedback regarding the Program.

### III. DISCUSSION

#### A. Unique Challenges in Establishing a Voluntary Self-Compliance Program for Tribal Governments

There are a number of unique challenges for ITG in establishing an effective Voluntary Self-Compliance Program for Tribal Governments.

1. Tribal Governments understand and expect federal agencies such as the IRS to consult and collaborate with them in developing new policies and programs, including programs such as the Voluntary Self-Compliance Program.

The Federal Government, including the IRS, has an obligation to consult with Tribal Governments on all matters that affect them. Federal Government departments and agencies must undertake “regular and meaningful consultation and collaboration with tribal officials in the development of federal policies that have tribal implications.” Executive Order 13175, Consultation and Coordination with Indian Tribal Governments (Nov. 6, 2000). “Each executive department and agency shall consult, to the greatest extent

---

<sup>1</sup> Due to the uniqueness of the Alaska Native Villages, ITG informed us at the outset of our work on this report that it has no expectation that any significant number of the Villages would wish to participate in the Program at this time. Accordingly, we determined not to survey the Alaska Native Villages for this report.

practicable and to the extent permitted by law, with tribal governments prior to taking actions that affect federally recognized tribal governments. All such consultations are to be open and candid so that all interested parties may evaluate for themselves the potential impact of relevant proposals.” Executive Memorandum of April 29, 1994, on Government-to-Government Relations with Native American Tribal Governments. If a program is developed without meaningful consultation and collaboration, the affected Tribes are likely to conclude that the federal agency has failed to meet its obligations under federal law. The development of a program without meaningful consultation and collaboration also is likely to result in skepticism on the part of the Tribes regarding whether the program will be beneficial for them.

## 2. Inadequate IRS guidance

The ACT delivered a report in June 2005 concluding that there is inadequate IRS guidance regarding many important and recurring Tribal issues. Since the issuance of the 2005 Report, there has been no additional guidance issued on these issues. The continuing lack of available guidance has contributed to a perception among Tribal Governments that issues that the Tribes believe are important are not important to the IRS.

## 3. Limited Tribal resources

In part as a result of the governmental status and limited resources available to Tribal Governments, relatively few Tribes have professional tax experts on staff, and there are only a handful of outside lawyers and tax specialists who focus their practices on Tribal tax matters. The fact is that most Tribes are advised by generalists – whether lawyers, accountants, or tribal employees without any special professional tax training. Also, in many Tribes, there is likely to be more staff turnover as compared with federal, state, and local governments, where there are more established civil service systems.

### **B. Development, Implementation, and Use of the Program**

The IRS established the Voluntary Self-Compliance Program as a result of a suggestion made in April 2003 by a representative of a Tribal Government in Oklahoma who was in attendance at one of ITG’s periodic “consultation listening meetings.” ITG holds these listening meetings so that Tribal Governments may raise issues of concern and offer suggestions regarding federal tax administration. A representative of an Oklahoma Tribe suggested that a program allowing the Tribal Governments to conduct their own compliance check and turn in the results to the IRS, rather than for the IRS to conduct the compliance check, would promote longstanding federal policy goals of tribal sovereignty and self-government as well as promote federal tax administration goals.

By way of background, a “compliance check” is a review to determine whether a taxpayer is adhering to various tax return, information reporting, and recordkeeping requirements. It consists of a review and reconciliation of a Tribal Government’s IRS filings, involving IRS forms such as the W-2, W-2G, W-3, W-4, W-9, 11-C, 730, 941, 945, 1042-S, 1096, and 1099. A compliance check does not directly relate to determining a tax liability for any past tax period, and does not involve the examination of books and records by the IRS pursuant

to Section 7605(a) of the Internal Revenue Code. Rather, a compliance check is a tool to help tribal officials and employees increase their voluntary compliance with the federal tax laws and to minimize the risk of errors in preparing and filing various tax and information returns. An important feature of a compliance check is that it is entirely voluntary, unlike an examination. A Tribal Government or member of another customer group need not acquiesce in an IRS request to do a compliance check. If the Tribal Government or other customer says “no,” it increases the likelihood that the IRS will select the returns in question for an examination in the near future, given the criteria that the IRS uses to select returns for examination. However, it is possible that the IRS will not select the returns for examination.

The Voluntary Self-Compliance Program allows Tribal Governments who are current on all taxes to perform their own review and reconciliation of these reports and report their findings to the IRS. Any problems that are then encountered can be corrected at little to no cost above the mandatory taxes owed.

After the April 2003 listening meeting, ITG floated the idea regarding the Program at other listening meetings over the next year and got a generally positive reaction to the idea. In November 2004 the Commissioner for the Tax Exempt and Government Entities Division of the IRS gave ITG the go-ahead to develop a Voluntary Self-Compliance Program for Tribal Governments, and by the summer of 2005 ITG had developed the pilot Program.

Because ITG has been invited to USET’s meetings on a regular basis since ITG was established in late 1999, ITG discussed its plan to implement the Program at a USET meeting in early 2005. Representatives of USET informed ITG that USET’s member Tribes would like to volunteer for the “pilot” phase of the implementation of the Program and ITG accepted their offer.

Three USET Tribes tested the Program, and the IRS selected one entity within each of the Tribes for the initial compliance checks.<sup>2</sup> The entities selected included a convenience store enterprise, a small bingo enterprise, and a small manufacturing enterprise. Of the Tribes that participated in the Program in the testing phase, one Tribe discovered some mistakes in its information returns and used the Program to correct the mistakes without penalties. For the other two Tribes, no compliance issues of any consequence were uncovered during the compliance checks, but the Tribes provided feedback to ITG regarding their experiences in conducting the compliance checks.

ITG made additional adjustments in the Form 13797 as a result of the testing phase and then formally launched the Program, which is known by the acronym “TEFAC” within the IRS, in December 2005. Tribal Governments wishing to participate in the Program and qualify for assistance from ITG in resolving any adverse findings from the compliance check must complete an on-line form entitled “Request to Conduct Tribal Evaluation of

---

<sup>2</sup> Tribal Governments often use more than one Employer Identification Number for tax reporting purposes, depending on the organization of their revenue raising activities and other government programs. The Form 13797 was designed for Tribal Governments to report their compliance checks on an entity-by-entity basis, with each EIN used to be considered one entity for this purpose.

Filing and Accuracy Compliance” or contact their ITG specialist. A Request must be submitted for each entity for which the Tribal Government wishes to conduct a compliance check, and the entity must be current in the filing of all federal tax returns and in the payment of all federal taxes in order to be eligible to participate in the Program. Penalties will be waived wherever permissible for Tribal Governments requesting assistance in effecting corrective actions uncovered by the compliance checks. Instead of registering with ITG to participate in the Program, a Tribal Government could choose to use the Form 13797 as an internal tool, allowing the Tribe to assess its own compliance without involving the IRS.

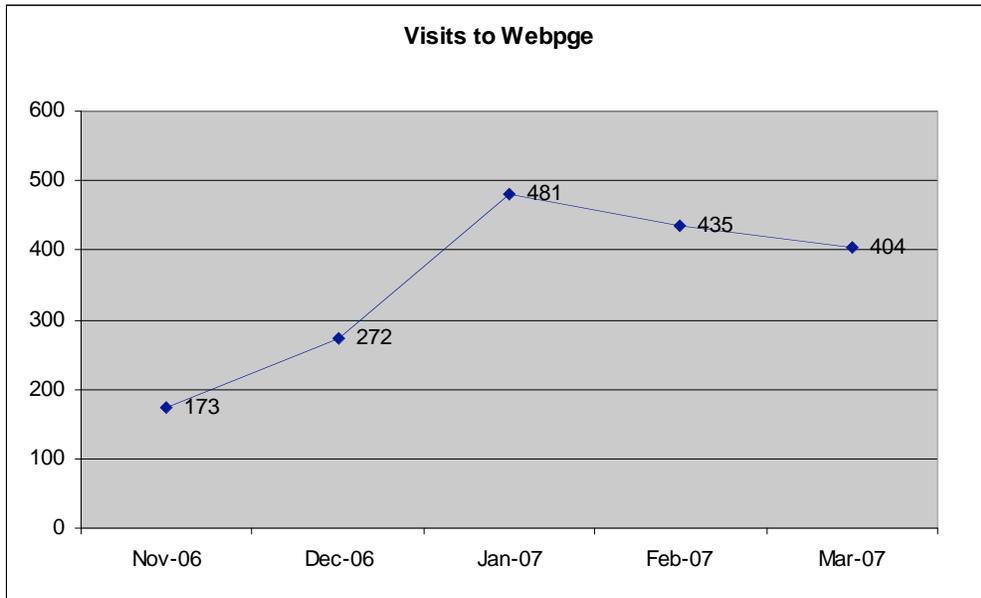
ITG officially announced the Program in special editions of ITG News, its regional newsletters, as well as in a headline story posted for two months on the ITG landing page within the IRS website. ITG senior staff also informed Tribal Governments of the Program at its periodic listening meetings, as well as at other meetings that it attended in the months after launching the Program. In addition, any time that ITG sends a letter to a Tribal Government requesting to do a compliance check, the letter briefly informs the Tribal Government about the Program. ITG’s written materials regarding the Program have not informed the Tribes that they might wish to use the Form 13797 as an internal tool only.

ITG has not developed any formal educational or other materials for use in informing Tribal Governments about the Program and explaining the reasons they might wish to participate.

Since the Program was launched in December 2005, only four Tribal Governments have participated in the Program. Of these four, one Tribe elected to have four entities within the Tribe conduct the compliance check. The four participating Tribes are located in California, Oklahoma, and Oregon. ITG senior staff reported that the four Tribes have taken considerably longer to complete the compliance checks than ITG expected. One Tribe was cleared by ITG to participate over a year ago and still has not completed the Program.

### **C. Feedback Obtained Regarding the Program**

When we commenced our work for this report, we asked ITG to begin tracking the number of visits to <<<http://www.irs.gov/govt/tribes/article/0,,id=141709,00.html>>>, the webpage within the IRS website that is devoted to describing the Program. This tracking was implemented on November 7, 2006, and the chart below shows the number of visits to the Program webpage since then:

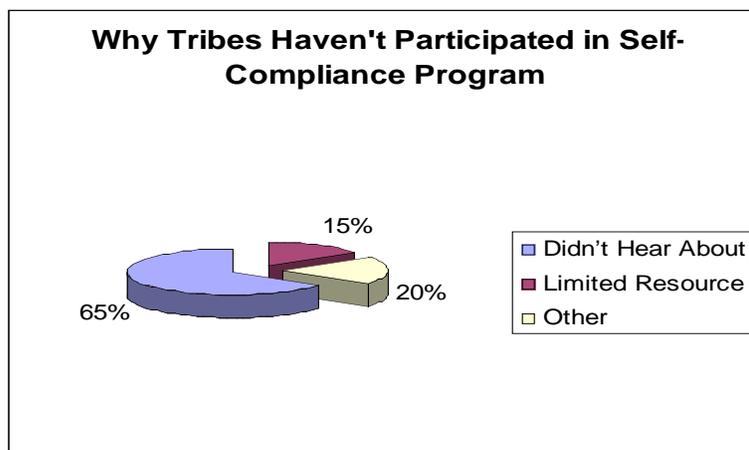


Our survey seeking feedback from Tribal Governments regarding the Program was mailed to Tribal Governments in January 2007, which likely contributed to the increase in visits to the webpage commencing that month.

During the months of January through the middle of March we received 39 responses to our survey from Tribal Governments. Our survey was not scientific, and there were some ambiguities in some of the responses. Nonetheless, we obtained a great deal of valuable feedback regarding the Voluntary Self-Compliance Program from the Tribal Governments.

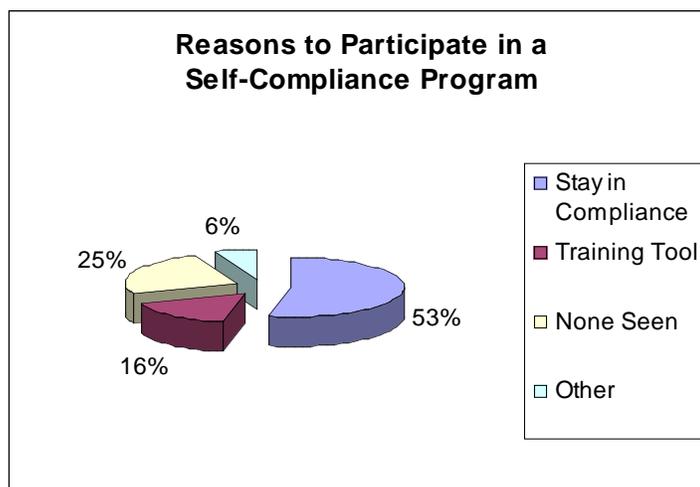
As discussed in more detail below, 64% of the Tribes responding to the survey did not know about the Program before the survey. Of the Tribes that had heard about the Program, only 42% knew what it was called. Many of the responding Tribes do not appear to have arrived at any viewpoint about whether it would be beneficial to participate in a self-compliance program. Others are skeptical that anything that the IRS is promoting could be beneficial for the Tribes.

Only 25% of the responding Tribes stated that they had considered participating in the Program. Of those that had not considered participating, nearly two-thirds stated they had not done so because they had not heard of the Program and 15% stated they lacked the resources to participate:

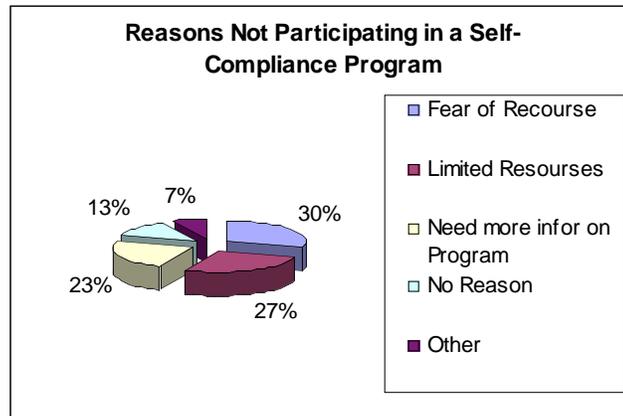


Other reasons given for not participating included “we think we don’t have any problems with these items,” the Program was “just introduced to us last year,” we “believe it may provide information to the Government/IRS that we don’t want to share,” “I am somewhat skeptical about having to apply with IRS and having to have them review/prepare report,” and we “just went through audit.”

We asked if the Tribes saw any benefits to participating in a self-compliance check program. Over half saw the benefit of staying in compliance and avoiding penalties key to participation, 16% noted that a self-compliance program would provide a good training tool for employees, and a few saw other benefits such as building a trusting relationship with the IRS and the fact that a self-compliance check would be less intrusive than a compliance check performed by the IRS. One quarter of those responding said they did not know or were not sure about the benefits of participating in such a program:



We also asked the Tribes if they saw any reasons *not* to participate in a self-compliance check program. There was a wide range of answers, with the primary one being the fear of recourse from the IRS and limited Tribal resources following a close second:



When asked if their Tribe would use the IRS’s self-compliance check template (i.e., the Form 13797) without registering with the IRS, approximately 87% of the respondents said they would consider using the template internally. In our view, this is one of the most striking results of the survey, particularly in light of the fact that ITG does not appear to have systematically promoted use of the Form 13797 as an internal tool for training employees, assessing compliance, and preparing for an IRS examination, at least in ITG’s written materials regarding the Program.

Only five of the Tribes responded that they have looked at the Form 13797. These Tribes generally found the document to be acceptable. One respondent suggested that there should be expanded inquiry regarding general welfare and retirement plans.

In addition to our surveys, we spoke by telephone with an attorney for USET to obtain his feedback regarding the Program based on the experience of the USET Tribes that tested the Program. He informed us that in his view, the Program provides an excellent opportunity for Tribal Governments to assess their compliance with federal tax laws with a minimum amount of intrusion by the IRS. When we asked him why he thought so few Tribes had decided to participate in the Program to date, he stated that he believes it may be due in part to the fact that the Program is relatively new. He also stated that he thought Tribes might have a perception that completing the Program involves more work than available resources will permit. He told us that he suspected it would typically take only a day or two to complete the Program and that from his perspective, “an ounce of prevention is worth a pound of cure.” He stated that he believes that the perception that the Program involves too much work could be combated through educational outreach.

#### IV. RECOMMENDATIONS

We have a number of recommendations that we believe will increase the likelihood that more Tribal Governments will decide to formally participate in the Voluntary Self-Compliance Program or at least make use of the Program materials internally as a tool to improve their federal tax compliance. With more Tribal Governments participating or using the materials internally, the relationship between ITG and the Tribal Governments will be

improved and the IRS's federal tax administration goals, in turn, will be more likely to be achieved.

### ***Recommendation 1: Improve Communication***

#### ***Improve Relationships with Regional Tribal Groups***

In gathering the information to prepare this report, we asked ITG senior staff many questions about ITG's consultation and collaboration with Tribal Governments in establishing the Voluntary Self-Compliance Program. Knowing these facts was important to us, given the understanding and expectation of Tribal Governments that federal agencies have a responsibility to consult and collaborate with the Tribes in developing programs that affect them. We were struck by the important role played by the USET Tribes in the development of the Program. ITG staff explained that this occurred because ITG has succeeded in developing a strong government-to-government relationship with USET and the 26 USET Tribes. ITG senior staff informed us that ITG has not succeeded in developing a similar relationship with other regional Tribal groups, although it has made at least occasional efforts to do so since ITG was established in late 1999. As a result, the Tribes other than the USET Tribes played virtually no role in the development of the Program. These other Tribes, as a result, may be more likely to be skeptical that the Program could be beneficial to them.

We believe that ITG should redouble its efforts to establish government-to-government relationships with other regional Tribal groups in the lower 48 states.<sup>3</sup> With strengthened government-to-government relationships between ITG and a broader group of Tribal Governments, it is inevitable that more Tribes will gain a greater awareness and understanding of the Program and, eventually, choose to participate in the Program in greater numbers. Strengthened relationships between ITG and the Tribes will serve federal Indian policy and tax administration goals in myriad other ways as well.

#### ***Adjust Protocols Used in ITG's Consultation Listening Meetings***

As noted above, ITG holds periodic "consultation listening meetings" throughout the country to afford Tribal representatives "the opportunity to raise questions and to offer suggestions on methods to enhance federal tax administration" for Tribal Governments. <http://www.irs.gov/govt/tribes/article/0,,id=150031,00.html> ITG senior staff explained that ITG does not circulate agendas for these meetings, because ITG does not want to "taint" the process by pre-ordaining the subject matter of the meetings. According to ITG, the primary purpose of the meetings is to *listen* to the Tribes' concerns about matters of federal tax administration and tax policy.

We are concerned that in focusing on *listening*, ITG is overlooking the fact that meaningful consultation and collaboration is a *two-way* process, one that necessitates that the IRS *inform* the Tribes about new programs that are being considered and *actively seek Tribal*

---

<sup>3</sup> We would be happy to meet with ITG staff to discuss how this recommendation might be implemented, as well as to facilitate relationships with these groups through our own personal contacts where we are able to do so.

*input* as an integral part of the program development. We believe that the absence of agendas for these meetings that identify matters that *ITG* wishes to discuss with the Tribes makes it far less likely that there will be meaningful consultation and collaboration. Without an agenda, the appropriate Tribal representatives would not know that it might be appropriate to attend the meeting, would not hear what *ITG* is contemplating, and would not have the opportunity to provide their views about what the program should entail.

We believe that *ITG* should give strong consideration to establishing and circulating agendas for the consultation listening meetings. The agendas should preserve the open-endedness of the first part of each meeting, which should continue to be devoted to listening to the Tribes' concerns. With more concrete information about the matters that *ITG* wishes to discuss in the second part of each meeting, we believe that the opportunity for meaningful, two-way consultation and collaboration between the IRS and the Tribes will be significantly enhanced

*Revise ITG's Form Letter Used to Initiate a Compliance Check*

In our view, the current form letter sent by *ITG* to Tribal Governments (see Exhibit D) is not as clear as it could be in explaining to the Tribe that a compliance check is being requested. The first two paragraphs of the letter contain confusing statements suggesting that *ITG* merely wishes to have a wide-ranging "discussion" with the Tribe regarding a variety of federal tax administration issues. The letter waits until the fourth paragraph to use the phrase "Compliance Check," and waits until the second page to discuss the Voluntary Self-Compliance Program. We recommend that the letter be revised to more clearly explain that *ITG* is requesting a compliance check and that the Tribe may perform the compliance check itself if it wishes to do so. Our suggested revision of the letter is attached as Exhibit E.

*Provide Focused Outreach and Education Regarding the Program*

To date, the IRS has provided only limited information to Tribal Governments regarding the Program. In many cases, *ITG*'s initial marketing campaign of putting information on the website and mentioning the Program at various events did not reach the Tribal representatives responsible for deciding whether to participate in the Program.

We recommend that *ITG* undertake more focused outreach and education regarding the Program. *ITG* should develop a presentation regarding the Program that it could present at specially convened regional workshops or in-house training sessions devoted to the Program. The presentation should include a full explanation of the IRS's compliance check and examination processes, along with a candid discussion of the reasons that Tribal Governments may or may not wish to participate in the Program. The presentation should walk participants through each page of the Form 13797 and any related Toolkits that are developed, so that the participants will have a concrete understanding of what the Program entails. The presentation also should advise the participants that the Form 13797 and Toolkits can be used internally, without registering with *ITG*.

If regional workshops are scheduled, *ITG* should inform the Tribes about the workshops using the same communication protocols that are used in informing the Tribes about *ITG*'s

consultation listening meetings: by sending individual letters to each Tribal leader in the region, having the ITG Specialists call their contacts at each Tribe, and publicizing the workshop in a special edition of ITG News and in a headline posted on the ITG website. ITG should schedule regional workshops at times and places that will be convenient for Tribal staff to attend, such as immediately before or after other regional meetings that such staff are likely to attend.

***Recommendation 2: Enhance Promotion of Internal Use of Form 13797***

ITG should enhance its promotion of the use of the Form 13797 as an internal tool for Tribes who wish to assess their federal tax compliance without involving the IRS. This promotion should take place everywhere that ITG promotes the Program: on ITG's website, in its other promotional materials regarding the Program, and in its statements in the field regarding the Program.

***Recommendation 3: Compartmentalize the Program by Tax Issues***

The Program is currently structured so that participating Tribes check and report on the entire range of their federal tax compliance. As noted above, however, a number of the survey respondents cited a lack of resources in explaining why they had not participated in the Program. ITG staff, too, noted that the four Tribes that have registered for the Program to date have taken considerably longer to complete the self-compliance checks than ITG expected. We believe that more Tribal Governments will choose to participate in the Program if it is compartmentalized into several smaller subparts, each of which could be conducted as a stand-alone self-compliance check in appropriate circumstances. For example, a stand-alone self-compliance check might be appropriate with respect to each of the following: (1) Forms W-2, W-3, W-4, and 941 reporting, (2) Forms W-9, 945, and 1099 reporting, (3) worker classification, (4) distributions to Tribal members, and (5) gaming or other industry-specific issues.

***Recommendation 4: Create Compliance Check Toolkits***

ITG should create a series of "Compliance Check Toolkits" for use with the Form 13797, to better facilitate the Tribes' participation in the Program or its internal use. One Toolkit should be created for use with each subpart, and the Toolkits should be posted on the webpage devoted to the Program.<sup>4</sup> As recommended above, we believe that the Program should be compartmentalized into several smaller subparts.

***Recommendation 5: Eliminate Open-Ended Questions from Form 13797***

The Form 13797 is generally clear and straightforward in guiding the Tribal representative through the steps that must be performed to complete the compliance check. Nevertheless, we have two suggestions for improving the content of the Form.

---

<sup>4</sup> We would be happy to assist ITG in developing the Toolkits as part of our ACT project and report next year.

First, we believe that open-ended questions should be eliminated. In our view, these questions fuel the perception that a central objective for the IRS in establishing the Program is to conduct a “fishing expedition” to assist the IRS in identifying returns for examination. We suggest that the portion of the Form entitled “Review of Forms” on page 3 be eliminated or redrafted with more specificity for this reason. We also believe that the question regarding “General Welfare Programs” on page 5 is too open-ended in its current form:

Is the Entity involved in the development and/or implementation of any programs that are designed to promote the general welfare of tribal members?

Virtually all Tribal laws and programs are established to promote the general welfare of the Tribe and its members. We suggest that the question be rephrased as follows (additions indicated by underscoring):

Is the Entity involved in the development and/or implementation of any programs providing cash or in-kind benefits to or for individual tribal members that are designed to promote the general welfare of tribal members?

Second, for many of the questions on the Form for which boxes are provided to check “Yes” or “No,” a third box should be provided to check “N/A” for “Not Applicable.”

### ***Recommendation 6: Rename the Program***

The Program name – “Tribal Evaluation of Filing and Accuracy Compliance” – is cumbersome and difficult to remember, as is the “TEFAC” acronym used by the IRS. We suggest that the name of the Program be changed to “Tribal Compliance Check,” shortened to the acronym “TCC,” which more clearly reflects the purpose of the Program, will be easier for Tribal Governments to remember, and should be used in all future materials. The toolkits that we suggest be created could be called “Tribal Compliance Check Toolkits,” shortened to “TCC Toolkits.”

### ***Recommendation 7: Be Patient***

Finally, we recommend that the IRS be patient as it waits for more Tribal Governments to participate in the Program. All of TE/GE’s other voluntary compliance programs took time to catch on with TE/GE’s customer groups. For example, only three customers chose to participate in the Employee Plans Office’s voluntary self-compliance program in the first two years of that program. Since then, thousands of customers have participated in that program. Over time, especially if the above recommendations are followed, more Tribes will participate in the Voluntary Self-Compliance Program or use the Form 13797 internally, resulting in enhanced federal tax compliance by the Tribes.

## **V. CONCLUSION**

We appreciate the time and support of ITG staff, as well as the time and comments of all those Tribal representatives and advocates who shared their views with us.

The recommendations set forth in this report are offered in the belief that the good work to date that has been accomplished by the IRS in creating ITG and operating within a respectful government-to-government relationship with Tribal Governments will be enhanced through the Voluntary Self-Compliance Program, more focused outreach and education, and more active consultation and collaboration with Tribal Governments.

These steps will enhance compliance opportunities and improve the relationship between the IRS and Tribal Governments.

## EXHIBIT A

**Lenor A. Scheffler, Sandra J. Starnes, and Mary J. Streitz  
Indian Tribal Government Representatives  
Advisory Committee on Tax Exempt and Government Entities  
Internal Revenue Service, Department of Treasury**

January 12, 2007

Dear Tribal Representative:

We are members of the IRS Advisory Committee on Tax Exempt and Government Entities, also known as the "ACT." We are writing to ask you to complete the enclosed survey to assist us in our information gathering for a public report that we are preparing for the IRS and the public from the ACT.

We do not work for the IRS. Rather, we were appointed to the ACT to represent the interests and concerns of tribal governments and tribal entities in matters of federal tax administration. Other members of the ACT represent federal, state, and local governments, tax-exempt entities, and employee plans. We serve on the ACT in a volunteer capacity. In our professional lives, two of us are lawyers in private practice who represent tribal governments and tribal entities. The other is a certified public accountant who is employed by a tribal government.

One of our responsibilities as members of the ACT is to provide feedback from tribal governments and tribal entities to the IRS regarding tax administration matters affecting tribes and tribal governments. This year, we have decided to prepare a report regarding the voluntary compliance check program for tribes and tribal entities that the IRS launched in 2006.

As part of our information gathering for this report, we are seeking your valuable input regarding the voluntary compliance check program by completing the enclosed survey or having an appropriate person or persons at your tribe complete the survey. You need not sign the survey if you prefer not to do so. However, if you are willing to be contacted for further discussion of the issues in the survey, please provide your name and contact information.

We will not share any specific answers that you provide to us with the IRS or include any specific answers in the report, only compilations of data gathered from all of the surveys. If you choose to provide your name so that we can contact you further, we will not share your name or your tribe with the IRS.

We would really appreciate your taking the time to respond to the survey and returning it to us in the enclosed stamped envelope, or to one of us by email or fax, on or before February 9, 2007. Our contact information is provided below and at the end of the survey.

We will be happy to share our findings with you. Also, our report will be completed and available to the public on June 13, 2007. If you have any questions about the survey, the report, or the ACT, please call us.

Sincerely,

Lenor A. Scheffler  
Minneapolis, Minnesota  
Tel: (612) 349-5687  
Fax: (612) 339-5897  
Email: [lscheffler@bestlaw.com](mailto:lscheffler@bestlaw.com)

Sandra J. Starnes  
Kingston, Washington  
Tel: (360) 297-9667  
Fax: (360) 297-9666  
Email: [sandra@pgst.nsn.us](mailto:sandra@pgst.nsn.us)

Mary J. Streitz  
Minneapolis, Minnesota  
Tel: (612) 340-7813  
Fax: (612) 340-8827  
Email: [streitz.mary@dorsey.com](mailto:streitz.mary@dorsey.com)

**SURVEY FOR TRIBES AND TRIBAL ENTITIES  
REGARDING IRS SELF-COMPLIANCE CHECK PROGRAM**

1. Have you heard about the IRS's voluntary compliance program that allows Tribal governments and Tribal entities to perform their own self-compliance check?
  - a. If yes, where did you hear about it?
2. Do you know the name of the self-compliance check program?
3. Do you know where you can go to find information about the self-compliance check program?
  - a. If yes, where?
4. Have you considered participating in the self-compliance check program?
  - a. If yes, have you?
  - b. If no, why not?
5. Would you use the IRS's self-compliance check list (referred to by the IRS as a "template") to see how you are doing if you didn't have to turn it into the IRS?
  - a. Have you?
  - b. Why or why not?
6. What benefits do you see for a Tribe to participate in a self-compliance check program?
7. What reasons do you see for a Tribe not to participate in a self-compliance check program?
8. What benefits do you see for the IRS to offer a self-compliance check program?
9. Have you looked at the IRS's self-compliance check template? If so, do you have any comments or suggestions regarding the template in any of the following areas?:
  - a. Organization
  - b. Ease of use

- c. Appropriateness of terminology
  - d. Adequacy of explanations and instructions
  - e. Are there any areas of inquiry that should be expanded?
  - f. Are there any areas of inquiry that should be reduced or eliminated?
  - g. Other
10. Have you ever heard the acronym “TEFAC?” If so, do you know what it means?
11. What IRS tax forms are you required to file?
12. Approximately how many employees do you have?
13. What type of Tribal revenue raising activities do you have? (Check all that apply)
- a. Gaming
  - b. Retail
  - c. Wholesale
  - d. Natural resources
  - e. Telecommunications
  - f. Housing
  - g. Other
14. What type of Tribal entities do you have for these activities? (Check all that apply)
- a. Business corporation
  - b. Nonprofit corporation
  - c. Partnership
  - d. LLC
  - e. Authority
  - f. Tribe operates activity directly
  - g. Other
15. Who prepares your tax returns?
- a. Self
  - b. Outside firm
16. Do you use the IRS’s web site and if so how often?
17. Do you have any feedback you would like to offer regarding the IRS’s website?

18. Do you have issues with the IRS that you would like the ACT committee to look into in the upcoming year?

If you need additional space for any of your answers, please feel free to attach additional pages.

Return Survey to one of the IRS's ACT Committee Members in the enclosed postage paid envelope:

Lenor A. Scheffler, Lawyer

Minneapolis, Minnesota

Tel: (612) 349-5687

Fax: (612) 339-5897

Email: [lscheffler@bestlaw.com](mailto:lscheffler@bestlaw.com)

Sandra J. Starnes, CPA

Kingston, Washington

Tel: (360) 297-9667

Fax: (360) 297-9666

Email: [sandra@pgst.nsn.us](mailto:sandra@pgst.nsn.us)

Mary J. Streit, Lawyer

Minneapolis, Minnesota

Tel: (612) 340-7813

Fax: (612) 340-8827

Email: [streitz.mary@dorsey.com](mailto:streitz.mary@dorsey.com)



**Lenor A. Scheffler, Sandra J. Starnes, and Mary J. Streit**  
**Indian Tribal Government Representatives**  
**Advisory Committee on Tax Exempt and Government Entities**  
**Internal Revenue Service, Department of Treasury**

January 12, 2007

Dear Tribal Advisor:

We are members of the IRS Advisory Committee on Tax Exempt and Government Entities, also known as the "ACT." We are writing to ask you to complete the enclosed survey to assist us in our information gathering for a public report that we are preparing for the IRS and the public from the ACT.

We do not work for the IRS. Rather, we were appointed to the ACT to represent the interests and concerns of tribal governments and tribal entities in matters of federal tax administration. Other members of the ACT represent federal, state, and local governments, tax-exempt entities, and employee plans. We serve on the ACT in a volunteer capacity. In our professional lives, two of us are lawyers in private practice who represent tribal governments and tribal entities. The other is a certified public accountant who is employed by a tribal government.

One of our responsibilities as members of the ACT is to provide feedback from tribal governments and tribal entities to the IRS regarding tax administration matters affecting tribes and tribal governments. This year, we have decided to prepare a report regarding the voluntary compliance check program for tribes and tribal entities that the IRS launched in 2006.

As part of our information gathering for this report, we are seeking your valuable input regarding the voluntary compliance check program by completing the enclosed survey or having an appropriate person or persons in your organization complete the survey. You need not sign the survey if you prefer not to do so. However, if you are willing to be contacted for further discussion of the issues in the survey, please provide your name and contact information.

We will not share any specific answers that you provide to us with the IRS or include any specific answers in the report, only compilations of data gathered from all of the surveys. If you choose to provide your name so that we can contact you further, we will not share your name with the IRS.

We would really appreciate your taking the time to respond to the survey and returning it to us in the enclosed stamped envelope, or to one of us by email or fax, on or before February 9, 2007. Our contact information is provided below and at the end of the survey.

We will be happy to share our findings with you. Also, our report will be completed and available to the public on June 13, 2007. If you have any questions about the survey, the report, or the ACT, please call us.

Sincerely,

Lenor A. Scheffler  
Minneapolis, Minnesota  
Tel: (612) 349-5687  
Fax: (612) 339-5897  
Email: [lscheffler@bestlaw.com](mailto:lscheffler@bestlaw.com)

Sandra J. Starnes  
Kingston, Washington  
Tel: (360) 297-9667  
Fax: (360) 297-9666  
Email: [sandra@pgst.nsn.us](mailto:sandra@pgst.nsn.us)

Mary J. Streit  
Minneapolis, Minnesota  
Tel: (612) 340-7813  
Fax: (612) 340-8827  
Email: [streitz.mary@dorsey.com](mailto:streitz.mary@dorsey.com)

**SURVEY FOR TRIBAL ADVISORS  
REGARDING IRS SELF-COMPLIANCE CHECK PROGRAM**

1. Have you heard about the IRS's voluntary compliance program that allows Tribal governments and Tribal entities to perform their own self-compliance check?
  - a. If yes, where did you hear about it?
2. Would you advise a client Tribal government or Tribal entity to participate in the self-compliance check program?
  - a. If yes, have you?
  - b. If no, why not?
3. Do you know where you can go to find information about the self-compliance check program?
  - a. If yes, where?
4. What benefits do you see for a Tribe to participate in a self-compliance check program?
5. What reasons do you see for a Tribe not to participate in a self-compliance check program?
6. What benefits do you see for the IRS to offer a self-compliance check program?
7. Have you looked at the IRS's self-compliance check list (referred to by the IRS as a "template")? If so, do you have any comments or suggestions regarding the template in any of the following areas?:
  - a. Organization
  - b. Ease of use
  - c. Appropriateness of terminology
  - d. Adequacy of explanations and instructions
  - e. Are there any areas of inquiry that should be expanded?

- f. Are there any areas of inquiry that should be reduced or eliminated?
  
- g. Other
  
- 8. What activities do the Tribes that you advise conduct? (Check all that apply)
  - a. Gaming
  - b. Retail
  - c. Wholesale
  - d. Natural resources
  - e. Telecommunications
  - f. Housing
  - g. Other
  
- 9. What types of Tribal entities do the Tribes that you advise use to conduct their activities? (Check all that apply)
  - a. Business corporation
  - b. Nonprofit corporation
  - c. Partnership
  - d. LLC
  - e. Authority
  - f. Tribe operates activity directly
  - g. Other
  
- 10. Do the Tribes that you advise typically prepare their own tax returns?
  
- 11. Do you use the IRS's web site and if so how often?
  
- 12. Do you have any feedback you would like to offer regarding the IRS's website?
  
- 13. Do you have issues with the IRS involving Tribes and Tribal entities that you would like the ACT committee to look into in the upcoming year?

If you need additional space for any of your answers, please feel free to attach additional pages.

Return Survey to one of the IRS's ACT Committee Members in the enclosed postage paid envelope:

Lenor A. Scheffler, Lawyer  
 Minneapolis, Minnesota  
 Tel: (612) 349-5687  
 Fax: (612) 339-5897  
 Email: lscheffler@bestlaw.com

Sandra J. Starnes, CPA  
 Kingston, Washington  
 Tel: (360) 297-9667  
 Fax: (360) 297-9666  
 Email: sandra@pgst.nsn.us

Mary J. Streitz, Lawyer  
 Minneapolis, Minnesota  
 Tel: (612) 340-7813  
 Fax: (612) 340-8827  
 Email: streitz.mary@dorsey.com

# EXHIBIT B

Form **13797**  
(November 2006)

Department of the Treasury — Internal Revenue Service

OMB No. 1545-2026

## Compliance Check Report

*This page to be completed by the IRS ITG Specialist.*

Use this form to fully document the activity and findings from your Compliance Check. This template is designed to report on data for one entity within the tribe (each Employer Identification Number (EIN) is considered to be one Entity for this purpose). If you decide to expand to additional tribal entities, pages 2-7 should be completed for each entity and attached to the final report. Only one summary sheet should be completed.

If you have any questions regarding a federal tax administration issue during the course of your Compliance Check, or any questions regarding the completion of this form, please check our [web resources](#), or contact:

Once the Compliance Check is completed, this document should be saved and returned on a 3½" diskette or CD-Rom to:

In order to assist you in completing the Compliance Check, our records currently indicate the following information in regard to this entity:

EIN: \_\_\_\_\_

Entity Name: \_\_\_\_\_

Address: \_\_\_\_\_  
\_\_\_\_\_

Required to file the following federal tax returns:

- Form 940 Employer's Annual Federal Unemployment (FUTA) Tax Return
- Form 941 Employer's Quarterly Federal Tax Return
- Form 943 Employer's Annual Return – Agricultural Employees
- Form 945 Annual Return of Withheld Federal Income Tax
- Form 990 Return of Exempt Organization
- Form 1065 Partnership Tax Return
- Form 1120 Corporation Income Tax Return
- Form 720 Quarterly Federal Excise Tax Return
- Form 730 Monthly Tax on Wagering
- Form 11-C Occupational Tax and Registration Return for Wagering
- Form 1042 Ann. Withholding Return for U.S. Source Income of Foreign Persons
- Form 2290 Highway Use Tax Return
- Form 1041 Fiduciary Tax Return
- Other \_\_\_\_\_

## Tribal Entity Reviewed

Employer Identification Number (EIN)

Name of Entity

Address

City

State

Zip

Activity of Entity

Year Entity Started

Performs Services for the Tribe in the Area of

*Which of the following tax issues are applicable to the entity:*

YES	NO	<u>Tax Issues Present</u>
<input type="checkbox"/>	<input type="checkbox"/>	<u>Employment Tax</u> (Withholding and FICA)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Information Reporting</u> (Forms 1099)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Tip Income</u> (do employees of the entity receive tip income)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Title 31</u> (Bank Secrecy Act compliance)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Natural Resources</u> (Fishing and Land based income exclusions)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Excise Tax</u> (Wagering)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Excise Tax</u> (Other)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Employee Plans</u> (pension and 401k plans) (are employees of the entity covered by an employee retirement or income deferral plan)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Exempt Organizations</u> (is the entity structured as a not-for-profit organization under Section 501 of the Internal Revenue Code)
<input type="checkbox"/>	<input type="checkbox"/>	<u>Tax Exempt Bonds</u> (does the entity have any outstanding obligations for tax exempt bonds issued)

*Is the Entity presently required to file:*

YES	NO	<u>Form</u>	<u>Form Description</u>
<input type="checkbox"/>	<input type="checkbox"/>	Form 940	Employer's Annual Federal Unemployment (FUTA) Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 941	Employer's Quarterly Federal Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 943	Employer's Annual Return – Agricultural Employees
<input type="checkbox"/>	<input type="checkbox"/>	Form 945	Annual Return of Withheld Federal Income Tax
<input type="checkbox"/>	<input type="checkbox"/>	Form 990	Return of Exempt Organization
<input type="checkbox"/>	<input type="checkbox"/>	Form 1065	Partnership Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 1120	Corporation Income Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 720	Quarterly Federal Excise Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 730	Monthly Tax on Wagering
<input type="checkbox"/>	<input type="checkbox"/>	Form 11-C	Occupational Tax and Registration Return for Wagering
<input type="checkbox"/>	<input type="checkbox"/>	Form 1042	Annual Withholding Return for U.S. Source Income of Foreign Persons
<input type="checkbox"/>	<input type="checkbox"/>	Form 2290	Highway Use Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form 1041	Fiduciary Tax Return
<input type="checkbox"/>	<input type="checkbox"/>	Form W-2	Wage and Tax Statement
<input type="checkbox"/>	<input type="checkbox"/>	Form W-2G	Certain Gambling Winnings
<input type="checkbox"/>	<input type="checkbox"/>	Form 8027	Employer's Annual Return of Tip Income and Allocated Tips
<input type="checkbox"/>	<input type="checkbox"/>	Form 1098-T	Tuition Statement
<input type="checkbox"/>	<input type="checkbox"/>	Form 1099-MISC	Statement for Recipients of Miscellaneous Income
<input type="checkbox"/>	<input type="checkbox"/>	Form 1099-R	Distributions from Retirement, Insurance, or Profit Sharing Plans
<input type="checkbox"/>	<input type="checkbox"/>	Form 8300	Cash Transactions Over \$10,000 Received in a Trade or Business
<input type="checkbox"/>	<input type="checkbox"/>	FinCEN Form 102	Suspicious Activity Report by Casinos and Card Clubs
<input type="checkbox"/>	<input type="checkbox"/>	FinCEN Form 103	Currency Transaction Report by Casinos

**Review of Forms**

Comment from your reviews of copies of the most recently filed tax forms. Include comments on whether the returns were accurately prepared; whether there were any returns processing problems, whether there was a balance due, whether there were any penalties imposed, etc.

If problems were encountered, how could they have been mitigated?

**Forms W-4**

- Does the entity have employees?  Yes  No
- Are Forms W-4 on file for every employee?  Yes  No
- Are all forms W-4 secured prior to initial payment?  Yes  No
- If No, what percentage was received after initial payment? \_\_\_\_\_
- Are all forms W-4 properly completed?  Yes  No
- If No, what percentage was incomplete? \_\_\_\_\_
- Are new forms W-4 secured each year on all individuals claiming to be exempt from income tax withholding?  No  Yes
- List any other comments from inspection of Forms W-4.

**Forms W-9**

- Does the entity make payments to vendors or independent contractors?  Yes  No
- Are Forms W-9 on file for every vendor or independent contractor?  Yes  No
- Are all forms W-9 secured prior to initial payment?  Yes  No
- If No, what percentage was received after initial payment? \_\_\_\_\_
- Are all forms W-9 properly completed?  Yes  No
- If No, what percentage was incomplete? \_\_\_\_\_
- List any other comments from inspection of Forms W-9.

**Forms 1099**

Are Forms 1099 filed for payments to all vendors and independent contractors for payments in excess of \$600 per year?  Yes  No

Is federal income tax withheld when required, due to invalid or missing Forms W-9?  Yes  No

**Employment Taxes**

Do Forms W-3, W-2 and 941 reconcile for the most recent calendar year?  Yes  No

If No, comment on the discrepancy and any actions needed or taken to resolve it.

Were there Federal Tax Deposit penalties assessed that could have been avoided?  Yes  No

Does the entity provide any fringe benefits (i.e., medical insurance, life insurance, tribal/employer-provided vehicle, tribal/employer-provided housing, etc.)  Yes  No

If Yes, list the type and whether they are deemed taxable in whole or part by the Entity.

Were taxable fringe benefits included on Forms W-2 for the applicable employee?  Yes  No

Does the entity pay Tribal Council members for their services on the Council (i.e. salary, meetings fees, stipends, etc.)?  Yes  No

Are the payments reported on Form W-2 or Form 1099?  Yes  No

If reported on Form W-2, are there withholding for FICA, Medicare, and Federal Income Tax?  Yes  No

Is the entity aware of Revenue Ruling 59-354?  Yes  No

Are internal controls present to ensure that a Form 1099 is not issued to an employee for an item that should be reported on Form W-2 (i.e. bonuses, excess reimbursement of expenses, personal use of a tribal asset, etc.)?  Yes  No

Is the level of tax filings consistent with the activity of the entity (i.e. Do the wages paid and withholding remittances appear accurate based on the size of the entity and the number of employees)?  Yes  No

If No, comment on the discrepancy and any actions taken to resolve it.

Does the Entity utilize a payroll service or Employee Leasing entity to file any required employment tax forms?  Yes  No

If Yes, list the name, address and EIN of the **service provider** as well as the specific forms filed on behalf of the entity.

EIN	Name			
Address	City	State	Zip	

Forms filed by payroll service on behalf of THIS entity

Is the entity required to file Form 940 (Employer's Annual Federal Unemployment (FUTA) Tax Return?  Yes  No

If Yes, does the entity participate in the State Unemployment Tax Act (SUTA) program?  Yes  No

If yes, are you aware of the relief from Federal Unemployment Tax that is available if you are in compliance with SUTA?  Yes  No

Comment on tax compliance in the following areas, including if the area is "not applicable" since the Entity has no involvement with the listed issue.

1. **General Welfare Programs**

Is the Entity involved in the development and/or implementation of any programs that are designed to promote the general welfare of tribal members?  Yes  No

If Yes, describe the nature of the programs and how the potential tax consequence of such program was determined.

2. **Employee Leasing**

Is the Entity involved in leasing employees **TO** or **FROM** another entity?  Yes  No

Lease TO another entity  Lease FROM another entity

Is the other entity controlled by the tribe or another tribe?  Yes  No

Have all federal tax filings and payments been properly made?  Yes  No

List any other comments on employee leasing.

3. **Excise Taxes**

Comment on the excise taxes that are applicable to the Entity as reflected on Forms 720, 730, 2290, and 11-C (include a comment on whether the essential government services exclusion was appropriately defined and applied to any communication or fuel taxes)

4. **Non-Gaming Distributions to Members**

Are there any distributions of non-gaming revenue made by the entity to any individuals (i.e. royalty income, business profits, land claim proceeds, etc.)?  Yes  No

If Yes, are Forms 1099 issued?  Yes  No

If No (Forms 1099 are NOT issued) comment on the reason.

List any other comments on Non-Gaming Distributions.

5. ***Housing Assistance for Law Enforcement Personnel Living in High Crime Tribal Areas***

Does the Entity provide any tax-free housing for law enforcement officials to reside in areas deemed to be a "high crime zone" by the Tribe?

Yes  No

If Yes, has the tribal governing body duly designated the zone and payments?

Yes  No

List any other comments on law enforcement housing.

6. ***Tip Income***

Does the Entity have employees who receive tip income?

Yes  No

If Yes, is there a voluntary Tip Agreement in place (Tip Rate Determination Agreement or a Gaming Industry Tip Compliance Agreement)?

Yes  No

What is the percentage of tipped employees who are participating in such an agreement? \_\_\_\_\_

If there are non-participating employees, do all of them report their tip income to the entity as required each month?

Yes  No

Are all employee tips properly reported on line 6c of Form 941?

Yes  No

Comment on whether the tip income being reported by employees appears accurate.

7. ***Bank Secrecy Act (BSA) Issues***

Is the Entity subject to Title 31 (gross gaming revenues of \$1 million or more per year, or the entity provides services such as check cashing, wire transfers, etc.)?

Yes  No

Does the entity have a designated BSA Compliance Officer?

Yes  No

Is that position solely dedicated to that task?

Yes  No

Does the entity have formal written BSA compliance program?

Yes  No

Is ongoing Bank Secrecy Act training held for all employees who interact with customers on the gaming floor, or work in security?

Yes  No

Comment on the level of filings of FinCEN Forms 102 and 103, specifically whether the number being filed is changing in proportion to any changes in the size of the gaming operation.

8. ***Per Capita Distributions of Gaming Revenues to Members***

Does the Tribe distribute any gaming revenues directly to tribal members?

Yes  No

Does the Tribe have a Revenue Allocation Plan (RAP)?

Yes  No

If Yes, is the tribe in compliance with it's RAP?

Yes  No

Is Form 1099 issued to each recipient?

Yes  No

Is proper withholding made from the distributions?

Yes  No

List any other comments on Per Capita Gaming Distributions

**9. Use of Trusts or Other Programs to Defer Distributions, or the Tax Consequence of Distributions**

Are any programs utilized by the tribe or tribal members to defer the tax consequence of a distribution, or to defer the actual distribution to a later date (i.e. through the use of a trust or other legal structure)?  Yes  No

Are they operated by the tribe?  Yes  No

Are they under contract or facilitated by a third party?  Yes  No

Were the guidelines in Revenue Procedure 2003-14 used?  Yes  No

If not, was a Private Letter Ruling secured on the deferral program?  Yes  No

List any other comments on use of Trusts.

**10. Aggregation Agreement on Gaming**

Does the Entity have an agreement with the IRS to aggregate slot machine wins for a patron in a gaming day?  Yes  No

If Yes, is the entity in compliance with that agreement?  Yes  No

List any other comments on aggregation agreements.

**11. Acceptance Agent Agreement on ITINs for Gaming Patrons**

Does the Entity have an agreement with the IRS to secure Tax Identification Numbers for gaming patrons from foreign countries who lack a social security number?  Yes  No

If Yes, is the entity in compliance with that agreement?  Yes  No

List any other comments on ITIN agreements.

**Actions / Corrections / Improvements**

List any actions that the Tribe has taken on its own, or plans to implement, to effect improvements in compliance as a result of conducting this Compliance Check.

List any actions where the IRS office of Indian Tribal Governments could assist the Tribe in effecting improvements to compliance (i.e. Outreach/Education, improved access to information, need for a Private Letter Ruling, implementation of a Tip Agreement, etc.) **Note:** Specific identified compliance concerns that may result in additional tax or penalties can be listed at the conclusion of this form if you are seeking IRS assistance and potential penalty relief.

**SUMMARY OF COMPLIANCE CHECK**

Name of Tribe			
Address of Tribe	City	State	Zip
Date Compliance Check Completed			
Tribal Entity Contact Name		Tribal Entity Contact Title	
Tribal Entity Contact Telephone Number		Tribal Entity Contact E-Mail Address	

The following information summarizes the results of the Compliance Check that was conducted  
(complete all applicable sections)

**EMPLOYER IDENTIFICATION NUMBER (EIN) CHANGES REQUIRED**

(List the affected EINs, check the column for the change(s) required  
and list an explanation for each change in the last column).

EIN	New EIN	Change of Address	Filing Requirement Change	Other	Explanation of Change
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	
	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	

**REQUIRED CORRECTIVE ACTIONS UNCOVERED BY COMPLIANCE CHECK**

Based on the results of this Compliance Check, we request assistance in effecting the following corrective actions with the understanding that penalties will be waived wherever permissible.

**Privacy Act Statement and Paperwork Reduction Act Notice**

This notice is given under the Privacy Act of 1974 and the Paperwork Reduction Act of 1995. The Privacy Act and Paperwork Reduction Act requires that the Internal Revenue Service inform businesses and other entities the following when asking for information.

The information on this form will carry out the Internal Revenue laws of the United States. We will comply with Internal Revenue Code (IRC) section 6109 and the regulations hereunder, which generally require the inclusion of an Employer Identification Number (EIN) on certain returns, statements, or other documents filed with the Internal Revenue Service. Information on this form may be used to determine which Federal tax returns are required to file and to provide related forms and publications. This Form will be disclosed to the Social Security Administration for their use in determining compliance with applicable laws. An EIN will not be issued unless you provide all of the requested information, which applies to your entity.

Respondents should be aware that notwithstanding any other provision of law, no person shall be subject to any penalty for failing to comply with a collection of information if it does not display a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by IRC section 6103.



## Enhancing Federal Tax Compliance

A Compliance Check is a review to determine whether a tribal entity is adhering to record keeping and information reporting requirements. It is neither an investigation under section 7605(a) of the Internal Revenue Code, nor an audit under section 530 of the Revenue Act of 1978. A Compliance Check does not directly relate to determining a tax liability for any past tax period, and does not involve the examination of books and records by the IRS. The Compliance Check is a tool to help tribal officials and employees increase voluntary compliance, and minimize the risk of error.

Tribal entities can now qualify to perform their own Compliance Check under a program known as TEFAC (Tribal Evaluation of Filing and Accuracy Compliance). Tribes interested in participating in TEFAC can submit a **Request to Conduct Tribal Evaluation of Filing and Accuracy Compliance**.

In order to assist with this process, the following reference items address many of the common federal tax administration issues for tribal entities. These can be reviewed to ascertain filing requirements for various forms, as well as the federal taxation and Bank Secrecy Act laws that impact tribal entities.

### [Request to Conduct Tribal Evaluation of Filing and Accuracy Compliance](#)

On-line request form to be completed and submitted by tribes requesting to participate in the TEFAC program.

### [Form 13797 - Compliance Check Report](#)

A template of what will be included in the compliance check.

### [Top Ten Problems Found Through Compliance Checks](#)

A list of the common compliance problems identified through Compliance Checks

---

## **Taxpayer Rights and Official Notices**

[Publication 1](#)

[Publication 3114](#)

[Notice 609](#)

## **Employment Taxes**

### **Forms and Instructions**

Form 940 ( [Form](#) ) ( [Instructions](#) )

Form 941 ( [Form](#) ) ( [Instructions](#) )

Form 943 ( [Form](#) ) ( [Instructions](#) )

### **Miscellaneous Information**

[Employment Tax FAQs](#)

[Federal Tax Deposit Instructions](#)

[Publication 15, Employer's Tax Guide](#)

[Publication 15-A, Employer's Supplemental Tax Guide](#)

## **Employment Tax Related Forms**

### **Forms and Instructions**

Form W-2 ( [Form](#) ) ( [Instructions](#) )

Form W-3 ( [Form](#) ) ( [Instructions](#) )

Form W-4 ( [Form](#) )

Form W-9 ( [Form](#) ) ( [Instructions](#) )

### **Miscellaneous Information**

[Revenue Ruling 59-354](#)

**[Taxable Fringe Benefits](#)**

**Miscellaneous Information**

[Publication 15-B, Fringe Benefits](#)

[Accountable Plans and W-2s](#)

[Reimbursing Business Travel Expenses](#)

**[Per Capita Distributions](#)**

**Miscellaneous Information**

[Per Capita FAQs](#)

[Publication 15-A, Employer's Supplemental Tax Guide](#)

**[Information Reporting](#)**

**Forms and Instructions**

[Form W-2G \( Form \) \( Instructions \)](#)

[Form 1098-Mortgage Interest Statement \( Form \) \( Instructions \)](#)

[Form 1098-T \( Form \) \( Instructions \)](#)

[Form 1099-MISC \( Form \) \( Instructions \)](#)

**Miscellaneous Information**

[Information Reporting FAQs](#)

**[Tip Income](#)**

**Forms and Instructions**

[Form 8027 \( Form \) \( Instructions \)](#)

**Miscellaneous Information**

[Tip FAQs](#)

[Non-Title 31 FAQs](#)

[TRDA/GITCA Comparison Chart](#)

**[Title 31](#)**

**Forms and Instructions**

[Form 8300 \( Form \)](#)

[FinCEN 102 \( Form \) \( Instructions \)](#)

[FinCEN 103 \( Form \)](#)

[FinCEN 103N \( Form \)](#)

[FinCEN 104 \( Form \)](#)

**Miscellaneous Information**

[BSA FAQs](#)

[Title 31 Anti-Money Laundering page](#)

**[Excise Tax – Wagering](#)**

**Forms and Instructions**

[Form 11-C \( Form \)](#)

[Form 730 \( Form \)](#)

**Miscellaneous Information**

[Excise Tax Guide](#)

[Excise Tax FAQs](#)

**[Excise Tax – Other](#)**

**Forms and Instructions**

[Form 720 \( Form \) \( Instructions \)](#)

**Miscellaneous Information**

[Excise Tax Guide](#)

[Excise Tax FAQs](#)

**[Employee Plans](#)**

**Forms and Instructions**

[Form 1099-R \( Form \) \( Instructions \)](#)

**[Exempt Organizations](#)**

**Forms and Instructions**

Form 990 ([Form](#)) ([instructions](#))

**Tax Exempt Bonds**

**Miscellaneous Information**

[Tax Exempt Bonds FAQs](#)

**Natural Resources**

**Miscellaneous Information**

[IRC 7873](#)

[Revenue Ruling 56-342](#)

[Fishing Rights FAQs](#)

[Natural Resources page](#)

**Highway Use Tax**

**Forms and Instructions**

Form 2290 ([Form](#)) ([Instructions](#))

**Income Tax Returns**

**Forms and Instructions**

Form 1065 ([Form](#)) ([Instructions](#))

Form 1120 ([Form](#)) ([Instructions](#))

**Miscellaneous Withholding Returns**

**Forms and Instructions**

Form 945 ([Form](#)) ([Instructions](#))

Form 1042 ([Form](#))

Form 1042-S ([Form](#)) ([Instructions](#))

For questions on Compliance Checks, please [e-mail](#) us. Be sure to include your name, your phone number and your email address so that we can respond to your question.

## **Request to Conduct Tribal Evaluation of Filing and Accuracy Compliance**

Requests must be submitted for each EIN on which you wish to conduct a self evaluation. To qualify, the entity must be current in the filing of all federal tax returns, and current in the payment of all federal taxes. If the IRS determines that you do not qualify under these provisions, we will inform you of the reason and provide a 30 day time period to remedy the apparent delinquency.

Complete this form online. The completed form will automatically be sent as an attachment via e-mail when you select the Submit Form button. The Reset Form button will clear all entries made on the form.

+++++

Entity Name:

Entity EIN (include dash):

Name of Tribe:

+++++

Name of Person Submitting This Request:

Title of Person Submitting This Request:

Telephone Number of Person Submitting This Request:

E-mail Address of Person Submitting This Request:

+++++

Comments:

**Submit Form**

**Reset Form**

## **Common Compliance Problems Identified through Compliance Checks**

1. FUTA – tribes still making tax deposits and/or filing Forms 940 when they are not required to pay FUTA because they participate in State unemployment.
2. Noncompliance with Revenue Ruling 59-354 - Tribal council members' pay being handled incorrectly and reported on a Form 1099 instead of a Form W-2, or being reported on a Form W-2 with FICA, Medicare and income tax withheld
3. Form 1099 problems
  - the forms were not prepared at all,
  - the forms were prepared incorrectly (amounts in the wrong box, etc.).
  - the forms were prepared but not submitted to IRS,
  - the incorrect copy was submitted to IRS,
  - not aware of the exception to filing on payments to corporations,
  - not aware of requirement to file 1099 for medical and legal expenses, even if the recipient is incorporated
4. Employment tax return filing/deposit problems
  - tax returns filed but no tax deposits were made,
  - deposits were made but no return was filed
  - deposits were made to incorrect period,
  - deposits were made using the wrong timetable (e.g. monthly deposits when should be semiweekly),
  - unaware of the "next day" deposit rule
  - Form 941 was filed with no Schedule B attached
5. Forms W-9 and W-4 are not being used, or are not being updated when necessary
6. Unaware of requirement to backup withhold if no TIN provided prior to payment
7. Payments to tribal members (committee members, gaming and non-gaming per capita) not reported on information returns, reported on the wrong information return, required withholding not done, or withholding done incorrectly
8. Amounts on Forms W-2, W-3, 1096 and 941 don't reconcile
9. Incorrect filing requirements for the entity, or there are other tribal entities that were not identified to the IRS as belonging to the tribe
10. Unaware of magnetic media filing requirement, and unaware of FIRE system (Filing Information Returns Electronically)



## EXHIBIT D

### INTERNAL REVENUE SERVICE Office of Indian Tribal Governments



TAX EXEMPT AND  
GOVERNMENT ENTITIES DIVISION

Employer ID Number:  
Telephone Number:  
Refer Reply to:

Re:

Dear

The office of Indian Tribal Governments is committed to working with Indian Tribes to address federal tax issues that impact them. To assist in attaining this objective, we would like to meet with you or your designated representative to discuss the various federal tax administration issues affecting the entity referred to above.

In order to accurately determine how we can best assist your Entity, I hope that we can discuss the various current tax issues, future changes that are planned that will have federal tax ramifications, previous contacts between the Tribe and the Internal Revenue Service, and any current federal tax concerns that may exist. This information will assist us in working with you to develop remedies to any existing problems, as well as to mitigate any potential future problems by identifying prospective needs.

As part of our meeting, I would like to review and reconcile the most recent copies of the following forms: 941, 940, 945, W-2, W-3, W-4, W-9, 1099, and 1096.

This Compliance Check is voluntary and is not an examination or inspection under Internal Revenue Code Sections 7602 or 7605(b), or an audit for purposes of Section 530 of the Revenue Act of 1978. If we decide to perform an examination, we would issue a separate letter to notify you.

In lieu of the office of Indian Tribal Governments conducting this Compliance Check, we have a Self Compliance Check Program that encourages interested tribal entities to conduct their own internal review using a template we provide, and with assistance available from our staff. Any tribal Entity that is current in the filing of all tax returns and full payment of all federal taxes can qualify. If you qualify and are interested in this opportunity, which includes a limited program for penalty-free correction of any errors found through the review, please contact me.

I hope that we can meet within the next 30 days, and I ask that your designated representative contact me so that we can schedule a mutually convenient time. I may be contacted at the telephone number listed above.

Sincerely,

Indian Tribal Governments Specialist  
Employee ID #

# EXHIBIT E

## INTERNAL REVENUE SERVICE Office of Indian Tribal Governments

**Employer ID Number:**

**Telephone Number:**

**Refer Reply to:**

RE:

The office of Indian Tribal Governments is committed to working with Indian Tribes to address federal tax issues that impact them. To assist in attaining this objective, we would like to meet with you or your designated representative to perform a Compliance Check.

This Compliance Check is voluntary and is not an examination or inspection under Internal Revenue Code Sections 7602 or 7605(b), or an audit for purposes of Section 530 of the Revenue Act of 1978. If we decide to perform an examination, we would issue a separate letter to notify you.

As part of our meeting, I would like to review and reconcile the most recent copies of the following forms: 941, 940, 945, W-2, W-3, W-4, W-9, 1099 and 1096.

In lieu of the office of Indian Tribal Governments conducting this Compliance Check, we have a Self Compliance Check Program that encourages interested tribal entities to conduct their own internal review using a template which can be found on the IRS website [www.irs.gov/tribes](http://www.irs.gov/tribes). We encourage all tribal entities to take this opportunity to exercise their sovereignty by conducting their own Compliance Checks.

IRS staff will be available to assist you upon your request. Any tribal Entity that is current in the filing of all tax returns and full payment of all federal taxes can qualify. If you qualify and are interested in this opportunity, which includes a limited program for penalty-free correction of any errors found through the review, please contact me.

If you choose to have the IRS conduct the Compliance Check, I hope that we can meet within the next 30 days, and I ask that your designated representative contact me so that we can schedule a mutually convenient time. I may be contacted at the telephone number listed above.

Sincerely,

Indian Tribal Governments Specialist  
Employee I.D. #

Proposal for an Exempt Organizations Voluntary Compliance Program

This page left intentionally blank

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

**PROPOSAL FOR AN EXEMPT ORGANIZATIONS  
VOLUNTARY COMPLIANCE PROGRAM**

**Betsy Buchalter Adler, Project Leader  
Sean Delany, Project Leader  
Bonnie Brier  
Julie Floch  
Suzanne Ross McDowell  
Ana Thompson**

**June 13, 2007**



Proposal for an Exempt Organizations Voluntary Compliance Program  
**PROPOSAL FOR AN EXEMPT ORGANIZATIONS VOLUNTARY COMPLIANCE PROGRAM**

*Voluntary compliance – as opposed to enforced compliance – must be our goal for several overriding reasons:*

- *First, enforcement is best suited for circumstances in which taxpayers are willfully seeking to evade their tax obligations ...*
- *Second, it is far preferable from a public policy standpoint when taxpayers pay voluntarily rather than pursuant to enforcement action ...*
- *Third, the IRS lacks the resources to do much more through enforcement ...*
- *Fourth, we need to identify ways to slowly transform attitudes toward the tax system to create new norms of behavior – namely, tax compliance.*

--National Taxpayer Advocate Nina Olson, September 2006<sup>1</sup>

### **Executive Summary**

We recommend the creation of a broad-based, formal, and continuing voluntary compliance program within the Exempt Organizations Unit of the Tax-Exempt and Government Entities Division. We recommend beginning with a transitional program that takes advantage of the compliance incentives created by new Code Section 6033(j), which revokes the tax-exempt status of exempt organizations that fail to file information returns or notices for three consecutive years. The transitional program would address an exempt organization's failure to file information returns in the 990 series as well as employment tax returns. Building on lessons learned from designing and implementing this transitional program, we recommend an ongoing program that would continue to address filing failures but would also allow exempt organizations to bring more complex and challenging instances of non-compliance to the Internal Revenue Service for resolution.

## **1. The Case for an Exempt Organizations Voluntary Compliance Program**

### **A. The Problem**

---

<sup>1</sup> Written Statement of Nina Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Government Affairs, Committee on Finance, United States Senate, *Hearing on the Tax Gap*, September 26, 2006, [www.irs.gov/pub/irs-utl/ntatestimonyfctax\\_gap072606.pdf](http://www.irs.gov/pub/irs-utl/ntatestimonyfctax_gap072606.pdf).

## Proposal for an Exempt Organizations Voluntary Compliance Program

The tax-exempt sector in the U.S. comprises some 1.6 million exempt organizations which control more than \$2.4 trillion in assets.<sup>2</sup> Given the sector's size and significance, the importance of insuring compliance with the tax laws governing exempt organizations is beyond question. The tax-exempt sector includes large organizations, such as hospitals and independent higher education institutions, that hold more than 75% of the assets in the sector, as well as small entities with meager resources, operating locally with modest budgets and volunteer staffing, frequently without access to tax guidance or other professional expertise.<sup>3</sup> However, as in other areas of its jurisdiction – and notwithstanding recent successful efforts to increase the rate of audits of exempt organizations and to accelerate the completion of those reviews – the Internal Revenue Service<sup>4</sup> continues to regulate exempt organizations with resources that are inadequate to the task of vigilant oversight over such a large and diverse constituency.<sup>5</sup> As a result, exempt organizations' compliance with the tax law is largely a matter of voluntary obedience.

Exempt organizations, like taxable enterprises, sometimes discover that they are out of compliance with the tax law and wish to correct that problem themselves, rather than waiting for enforcement attention from the IRS. However, exempt organizations currently have no formal self-correction program of general applicability. As a result, self-correction efforts vary widely, both in manner and in efficacy. For example, an exempt organization might discover problems such as non-filing of annual information returns, failure to report employee wages and benefits and remit payroll taxes, or failure to report unrelated business income and pay any taxes due. Depending on the expertise and information available to it, the organization might seek assistance through its regional IRS office, the IRS Closing Agreements Coordinator in Dallas, Texas, or a sympathetic contact within the IRS at some other location. That contact might be at the national level, perhaps in the Exempt Organizations Rulings & Agreements office or the

---

<sup>2</sup> *Tax-Exempt and Government Entities Division At-a-Glance*, [www.irs.gov/irs/article/0,,id=100971,00.html](http://www.irs.gov/irs/article/0,,id=100971,00.html). All statutory and regulatory references in this Report, unless otherwise stated, are to the Internal Revenue Code of 1986, as amended, and accompanying Treasury Regulations.

<sup>3</sup> *National Taxpayer Advocate, 2005 Annual Report To Congress*, Taxpayer Advocate Service, December 31, 2005, p. 293, [http://www.irs.gov/pub/irs-utl/section\\_1.pdf](http://www.irs.gov/pub/irs-utl/section_1.pdf).

<sup>4</sup> References to the "IRS" or the "Service" refer to the Internal Revenue Service.

<sup>5</sup> Only 1% of the exempt organizations that are under the IRS' jurisdiction are subject to audit each year. *Reviewing IRS Policies and Procedures To Leverage Enforcement Recommendations (RIPPLE)*, p. 196 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 9, 2004); see also, *Trends in Exempt Organizations Function Enforcement Activities for Fiscal Years 2001 – 2005*, Treasury Inspector general for Tax Administration, September 22, 2006 (Reference Number: 2006-10-157) ("The EO function improved its ability to identify noncompliant organizations, but some compliance indicators decreased in FY 2005 due to a redirection of resources."); Independent Sector submits letter to the Senate and House Appropriations Financial Services and General Government Subcommittees, April 10, 2007, <http://www.independentsector.org/programs/gr/IRSappropr.htm>.

Proposal for an Exempt Organizations Voluntary Compliance Program  
EO<sup>6</sup> Examinations office, but it may be a person without any subject-matter nexus or other connection to the problem. Here are some examples of non-compliance issues described to us by lawyers and accountants practicing in this area:

- After its founder died, a small family foundation failed to file Form 990 PF, pay the Section 4940 excise tax, or meet the minimum distribution requirements under Section 4942. These problems were discovered when the founder's brother asked counsel to review the foundation's records.
- A voluntary employee benefits association described in Section 501(c)(9) inadvertently failed to file Form 990-T or pay unrelated business income taxes for a number of years. This omission was only discovered when newly engaged counsel was asked to review the Form 990s that the organization had already filed.
- An organization with an all-volunteer board had gross receipts above the \$25,000 Form 990 filing threshold for a number of years, but had not filed Form 990 because the organization's officers did not understand the filing requirements and had received incorrect advice about the obligation to file. New directors who were aware of the filing requirements joined the board, and wanted to bring the organization into filing compliance. However, the board was reluctant to file due to the organization's past delinquencies.

The absence of a formal mechanism to voluntarily resolve compliance failures has led to the evolution of a dual-class system for exempt organizations: the represented and the unrepresented. Larger organizations with counsel familiar with the tax laws, or accountants accustomed to negotiating the intricacies of IRS regulation, are able to resolve their problems relatively quickly, often in the organization's favor, whether or not the result in one instance is consistent with the result in other instances with similar fact patterns. Those without access to qualified professional assistance often flounder. They may contact IRS personnel who are unable to help or, worse, they may be paralyzed into continued inaction by their uncertainty as to what course to take. Even those who do have access to qualified assistance may obtain relief from the IRS on terms and conditions that vary from those accorded to other, similarly situated organizations. The Exempt Organizations Closing Unit, the only mechanism within the IRS for the voluntary resolution of compliance problems with centralized record-keeping, is seldom used by practitioners to address nonfiling or other issues.

By contrast, several other areas of the Tax Exempt and Government Entities Division ("TE/GE") have long operated formal voluntary compliance programs covering a broad

---

<sup>6</sup> References to "EO" refer to the Exempt Organizations Division of the Tax Exempt and Governmental Entities ("TE/GE") Division of the Service.

range of obligations. Employee Plans (“EP”), Tax-Exempt Bonds (“TEB”), and, more recently, Indian Tribal Governments (“ITG”) each offer regulated entities an opportunity to correct specific compliance problems predictably and expeditiously, saving resources for both the regulated entities and the IRS. While the interests that create incentives for participation in those programs beyond the desire to become legally compliant are different than the concerns that may apply to most exempt organizations’ noncompliance -- for example, relationships with third parties in EP (employees with pension interests) and TEB (bond investors) – the success of those programs suggests that carefully designed broad-based voluntary compliance programs can succeed. In the past, the IRS has offered only narrowly drawn and time-limited programs for exempt organizations, but those experiences also suggest that an ongoing voluntary compliance program for exempt organizations may be feasible on a broader scale.

## B. A Voluntary Compliance Program for Exempt Organizations

The Pension Protection Act of 2006 provides an opportunity to introduce an ongoing, broad-based voluntary compliance program for exempt organizations<sup>7</sup>. The principal tool for determining the compliance of exempt organizations is the information contained in annual information returns filed by those organizations on Form 990 or 990PF.<sup>8</sup> The overwhelming majority of exempt organizations filing those annual information returns are smaller organizations, with fewer than \$1 million in assets.<sup>9</sup> At present, the true extent of exempt organizations’ noncompliance with this annual filing obligation is unknown and, in fact, unknowable, because organizations with less than \$25,000 in assets and revenues during any reporting period have been excused from filing the return. The unquantifiable universe of exempt organizations that have either outgrown that exception or, conversely, have diminished in assets or revenues to fall below the filing threshold precludes that calculation.<sup>10</sup> However, the IRS has estimated that

---

<sup>7</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat 780.

<sup>8</sup> *Policies and Guidelines for Form 990 Revision*, P. 23 (Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities, June 7, 2006). Churches, synagogues, mosques, and other houses of worship are not required to file annual information returns. IRC Section 6033(a)(3). In this Report, when we refer to exempt organizations in the context of their reporting obligations, we mean only those organizations that are, in fact, obligated to report, <http://www.irs.gov/pub/irs-pdf/p4344.pdf>.

<sup>9</sup> According to the Urban Institute’s Center for Charitable Statistics, 483,989 of the 576,794 organizations that filed Form 990 in the two year period preceding January 2006 reported revenues of under \$1 million, and 459,311 of those organizations reported assets of under \$1 million. See National Center for Charitable Statistics, <http://nccsdataweb.urban.org> (last visited Apr. 21, 2007).

<sup>10</sup> New Section 6033(i), enacted by the Pension Protection Act of 2006, imposes an obligation on organizations recognized as exempt under Sections 501(c)(3) and (c)(4) to file an abbreviated annual electronic notification with the IRS with respect to annual periods beginning after 2006 if their gross receipts are normally below the 990-series filing threshold (currently \$25,000). Their tax-exempt status will be automatically revoked if they fail to do so for three consecutive years. IRC Sec. 6033(j). This additional reporting should enable the IRS to identify with greater precision the extent of nonfiling noncompliance.

Proposal for an Exempt Organizations Voluntary Compliance Program noncompliance is extensive, noting that in approximately 24% of the cases examined in one study of the problem, the person responsible for maintaining the organization's books and records was unaware of the obligation to file an annual information return.<sup>11</sup>

With the enactment of new Section 6033(j), as part of the Pension Protection Act, those organizations will face automatic revocation of exempt status for failure to file information returns for three consecutive years beginning after 2006. Organizations that have lost their exemption due to nonfiling must apply for reinstatement, a process that entails significant cost not only for the organization itself but for the Service.<sup>12</sup> Our proposed voluntary compliance program (VCP), therefore, begins with a transitional segment designed specifically to offer delinquent exempt organizations an opportunity to avoid the automatic revocation looming in the near future. Based on lessons learned from this transitional segment, our proposed VCP would then become an ongoing program with eligibility criteria designed to address other issues of non-compliance.

Bringing non-filing organizations into the system will facilitate IRS regulation and public scrutiny of exempt organizations that have previously operated “under the radar.” It will prevent the automatic revocation of tax-exempt status and the attendant waste of resources (by both the IRS and the revoked organizations) that will otherwise be expended on efforts to reinstate exempt status. A widely publicized VCP with clear entry standards and consistently applied consequences will enable even volunteer-run organizations to bring themselves into compliance without professional aid. By first addressing nonfiling problems, the IRS can pilot a voluntary compliance program that can be expanded to include additional areas of non-compliance, following evaluation and appropriate modifications. A voluntary compliance program that invites participation from a diverse group of exempt organizations and covers a wide range of compliance issues will enable the IRS to allocate enforcement resources more efficiently (particularly if an extension of the statute of limitations, for issues other than non-filing as such, is a condition of participation) and to understand better the compliance challenges that face exempt organizations.

In our view, it is important to remember why Form 990 and its variations are known as “information returns”: their primary purpose is not the collection of taxes or penalties but the collection of financial data and other particulars to meet enforcement and other objectives. The Service requires Form 990 and its variations because, as a matter of law enforcement and of tax policy as well, both the Service and the public want exempt organizations to provide that information. If an exempt organization has been

---

<sup>11</sup> Exempt Organizations Nonfiler Study Report of Findings, December 1994.

<sup>12</sup> This new burden is likely to fall on the EO determinations group just as (if IRS predictions are correct) they will have finally cleared their accumulated backlog of tax exemption applications.

delinquent in filing its information returns, it is not only good tax policy but also a wise use of limited enforcement resources to offer a well-publicized and straightforward procedure for that organization to come back into compliance with the law by providing the missing information. The amount of funds collected in non-filing penalties should be of less value to the Service, especially when netted against collection costs, than the information that an effective VCP would generate.

We describe our proposed VCP, together with the reasons behind our recommendations and the principles that we suggest should guide VCPs in the EO Division, in Parts 4 and 5 of this Report. First, however, we describe the process that led us to make these recommendations.

## **2. The Process**

The ACT obtained information about compliance issues and practices as well as the history of VCP programs from the perspective of various sectors within the TE/GE Division, including EO, EP, TEB, and ITG; private practitioners; and the regulated entities themselves. The ACT obtained this information through a series of interviews with IRS staff and private practitioners (primarily tax attorneys and accountants); a review of public and private reports, articles, papers and studies; and a detailed (but anonymous) questionnaire distributed primarily to attorneys and accountants practicing in this field.

Our interviews covered (a) the history and rationale of various VCP programs within TE/GE; (b) the types of EO noncompliance issues seen most frequently and current and past procedures for handling them; (c) how the EO Division communicates with exempt organizations about compliance issues, especially the challenges that the EO Division faces in contacting those who may not have filed a return for many years; (d) communications and outreach programs in general; and (e) different perspectives on which noncompliance issues lend themselves most readily to a voluntary compliance program. We attach a list of those interviewed for this report as Appendix 1. In addition, as Appendix 2, we attach a detailed bibliography of the written materials that we consulted in preparing this report.

As background for this project, we also distributed a detailed questionnaire to a range of practitioners in order to understand the types of noncompliance issues they observe or experience most often and to learn how they were (or were not) addressed. We also sought comments from these respondents regarding various components of a potential voluntary compliance program. The questionnaire was distributed in the fall of 2006 to various professional groups including the Exempt Organizations and Health Care Committees of the American Bar Association's Tax Section and the American Institute

Proposal for an Exempt Organizations Voluntary Compliance Program of Certified Public Accountants. What follows are some highlights of the survey responses.<sup>13</sup>

#### A. The Range and Frequency of Noncompliance Issues

The most frequently cited issue was the failure to file a required form, followed by late filing and inaccurate or incomplete filings. The most frequently cited reason for failure to file was the fact that the organization (often a small one) was run by volunteers who were unaware that the organization was required to file. Respondents also mentioned problems with failing to file, or improperly completing, payroll tax reporting forms and failure to pay withholding taxes; mischaracterization of exempt status; discovery of an inadvertent excess benefit transaction; confusion about or inaccurate reporting of political activities; and the identification of unrelated business taxable income.

#### B. Experience with the IRS When Addressing Noncompliance Issues

Respondents did not always contact the IRS to resolve noncompliance; some simply began complying from that point forward. However, among those that contacted the IRS, most acted through a lawyer or accounting professional; only three respondents indicated that the non-filer's own staff made the contact. Approximately one-third of respondents contacted a familiar person at the IRS in Washington; another third contacted the EO Closing Agreement Coordinator; and the remainder made a "cold call" to their IRS District Office or to Washington. The most frequently cited means of resolution was oral advice, followed by written advice from the IRS or a confirming letter from the organization or its representative. Only three respondents indicated that they resolved the matter through a closing agreement. As to consistency with the resolution of similar issues, thirteen respondents indicated that there had been consistency while four said that there had not.<sup>14</sup> Responses were mixed regarding when and how the organization was identified, but most respondents believed that being able to approach the IRS anonymously was very important.

#### C. Opinions on Different Aspects of a Voluntary Compliance Program

When asked which issues should be addressed by a voluntary compliance program, the majority of responders cited filing issues: failure to file, late filing, inaccurate filing, mistaken reporting of political activities or failure to report unrelated business income.

---

<sup>13</sup> We recognize that the survey does not lend itself to definitive conclusions due to the small size of the respondent pool and the fact that we were not able to poll organizations that are not represented by professional advisors. Moreover, not all of the respondents answered all of the questions.

<sup>14</sup> The high level of consistency that our limited sample of professional advisor responders cited in the resolution of similar issues may be due to nothing more than practitioners' tendency to use a single IRS contact for these purposes.

Responses were mixed as to whether organizations would be willing to pay a user fee, but assuming the existence of such a fee, the great majority favored a sliding scale.

### 3. The Context

Regardless of the issues addressed or the division within TE/GE that administers the program, existing voluntary compliance programs within TE/GE share five basic elements:

1. The program is available to a **defined set of eligible exempt organizations**;
2. The program offers to resolve a **specific issue** or set of issues;
3. The program is **clearly structured**, with written guidance that spells out a process and predictable outcomes for eligible organizations that follow its rules;
4. The program is **voluntary** and eligible organizations must apply for inclusion; and
5. The program provides **finality** through closing agreements or other documentation upon which the participating organizations can rely.

Although the EO Division of TE/GE does not currently have a VCP, it has operated such programs on a limited scale in the past to address relatively narrow compliance problems. By contrast, several other divisions within TE/GE have had such programs for more than fifteen years, including comprehensive programs that address a wide array of compliance problems. A table comparing key characteristics of the VCP programs in TE/GE to the program recommended in this Report is attached as Appendix 3. Understanding both the limitations and successes of these programs is vital in evaluating whether a VCP is practical for the EO Division.

#### A. Voluntary Compliance Initiatives in the Employee Plans Division

Before 1991, the EP Division did not have a formal VCP. If a plan sponsor discovered qualification failures that were not eligible for specific statutory and regulatory relief, the only way to remedy the failure was to disclose it to the IRS, with no guarantee that the qualified status of the pension plan would not be threatened. This was problematic for the IRS upon audit as well. Agents were reluctant to use the full sanctions available, as the disqualification of the plan harmed innocent employees by revoking the tax-exempt status of their pension plans.

In the 1990s the IRS began a series of voluntary compliance programs that focused solely on operational failures, in which a plan sponsor had failed to follow the terms of a

Proposal for an Exempt Organizations Voluntary Compliance Program plan document.<sup>15</sup> By the mid 1990s, there were increased demands from the regulated community to expand the program. In response, the IRS promulgated Revenue Procedure 98-22 to create a broader corrections program, the Tax Sheltered Annuity Voluntary Compliance Program. This program became a formal part of the Employee Plans Compliance Resolution System (“EPCRS”) upon the reorganization of the IRS in 2000. Revenue Procedure 2006-16 clarified the types of factors to be considered for self-correction, gave examples of types of failures, and provided remedies.

Since 1998, EPCRS has grown into a comprehensive system of correction programs, which currently include the Self-Correction Program (“SCP”), the Voluntary Correction Program (“VCP”), and the Audit Closing Agreement Program (“Audit CAP”). SCP is available to certain plan sponsors that have established compliance practices and procedures, and want to correct insignificant operational failures. There is no fee or sanction for participation in this program. VCP is available to plan sponsors that wish (before audit) to obtain TE/GE approval for correction of certain qualified plans. There is a limited fee for participation, and there are also special procedures for anonymous and group submissions. Under Audit CAP, the plan sponsor may correct a failure that has been identified on audit and pay a sanction. This sanction will be based on the nature, extent and severity of the failure. Annual revenue procedures clarify the latest programs and offer links to available guidance on the IRS website.

Revenue Procedure 2006-27, which runs to 116 pages, lists the general principles that govern these correction programs and provides detailed information for participation in the program, including model forms. EPCRS was established to encourage sponsors to adopt principles for proper plan operation and to make voluntary and timely corrections. Under the EPCRS, voluntary correction is available to address “plan document failures” (e.g., a plan provision, on its face, does not satisfy code requirements), “demographic failures” (e.g., a plan’s design or operation fails to satisfy the nondiscrimination requirements), and “employer eligibility failures” (e.g., a plan is not eligible under Section 403(b) because its sponsor is not a Section 501(c)(3) organization), as well as operational failures resulting from sponsor noncompliance with a plan’s stated terms. The program excludes from eligibility conduct constituting egregious failure, diversion or misuse of plan assets, and abusive tax avoidance transactions.

Eight general principles guide EPCRS. First, sponsors and other administrators should be encouraged to establish administrative practices and procedures that ensure compliance. Second, sponsors and other administrators should satisfy plan document requirements. Third, sponsors and other administrators should make voluntary and timely correction of plan failures so as to protect participating employees from harm to

---

<sup>15</sup> Revenue Procedure 92-89, 1992; Revenue Procedure 93-36, 1993; Revenue Procedure 94-62, 1994; see *Self-Correction Under EPCRS: Counseling Clients in an Evolving Area*, David T. Cowart, American Bar Association-Section of Taxation, 2004 Midyear Meeting.

their plans. Fourth, voluntary compliance is promoted by a program of limited fees for voluntary corrections approved by TE/GE. Fifth, fees and sanctions should be graduated so as to provide an incentive for correction. Sixth, sanctions for plan failures identified on audit should be commensurate with the nature of the violation. Seventh, administration of EPCRS should be consistent and uniform. Finally, sponsors should be able to rely on the availability of the programs in taking corrective actions. TE/GE continues to solicit comments from the marketplace in order to update and improve these programs.

The EP website provides guidance on the procedures applicants must follow in order to participate. Potential users complete the VCP Application Guide (available both on the website and in the appendix of Rev. Proc. 2006-27) to first determine whether they qualify for the program. The guide provides sample formats for submission, and explains the documents that must be attached and the fee charged to participate (depending on the number of participants in the plan, the fee ranges from \$750 to \$25,000). Upon receipt of the application, TE/GE sends the applicant an acknowledgment letter, indicating the next steps in the process.

According to the IRS Data Book, the volume of VCP participation is steadily rising. In 2005 there were 1,514 cases; in 2006 there were 2,935 cases.<sup>16</sup>

#### B. Voluntary Compliance Initiatives in the Tax-Exempt Bonds Division

In May 1993, the General Accounting Office<sup>17</sup> studied taxpayer compliance in the tax exempt bond area. In its report, the GAO suggested that improvements in taxpayer compliance in this area would require both policy changes at the IRS and Congressional adoption of legislative changes. The GAO report highlighted IRS reliance on voluntary compliance and its lack of enforcement efforts targeted to areas of probable noncompliance. The GAO report also noted that mechanisms to deter noncompliant behavior needed to be better communicated to the marketplace. Finally, the report expressed concern that in some cases the IRS seemed reluctant to use the full weight of its enforcement authority, since that approach punished investors in these bonds, who were innocent parties to these transactions, rather than the parties responsible for the abusive transactions, and it often was disproportionately severe.

Following the GAO report, a TEB compliance program was added. In 2001, after the IRS reorganization, the current TEB Division adopted a voluntary compliance program known as the Voluntary Closing Agreement Program (“TEB VCAP”). It was established to encourage bond issuer compliance and enable issuers to correct infractions or offset them by payments to the IRS. Revoking the exempt status of bonds would become a

---

<sup>16</sup> *IRS Data Book 2005* and *IRS Data Book 2006*, Department of the Treasury Internal Revenue Service, Publication 55B (Washington DC, March 2006 and March 2007).

<sup>17</sup> *Improvements for More Effective Tax-Exempt Bond Oversight*, GAO Tax Policy and Administration, GAO/GGD-93-104, May 10, 1993.  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

Proposal for an Exempt Organizations Voluntary Compliance Program last resort. The TEB VCAP was designed to be a formal process, open to all interested parties. It was publicized throughout the bond community, to encourage compliance before exam initiatives began. The ultimate goal was (and still is) to correct compliance problems with minimal damage to investors. Currently the VCAP program is overseen by TEB's Compliance and Program Management group, as it is part of the effort to develop outreach and education efforts and encourage voluntary compliance by issuers.

IRS Notice 2001-60 provides procedures for issuers of tax-exempt bonds to resolve tax law violations through closing agreements. It is intended to encourage issuers and conduit borrowers to correct violations (or pay an appropriate penalty) so as to avoid the taxing of innocent bondholders upon IRS discovery of those violations. It defines the violations that are eligible for remedy and provides information to taxpayers on the procedures to use in resolving violations. The program is not available when violations can be corrected through existing remedial action provisions or closing agreement programs contained in regulations or published guidance, when the bond issue is already under examination, when the tax-exempt status of the bonds is at issue in a court proceeding, or when the IRS determines that the violation is due to willful neglect. Inquiries and discussions can be initiated on an anonymous basis.

Typically TEB first makes a threshold determination as to whether the problem can be self-corrected. If not, a closing agreement is the next option. The procedures for requesting a closing agreement under the program require that a statement be submitted under penalty of perjury stating, among other things, a description of the violation and how it was discovered, the procedures and policies to be instituted to ensure future compliance, that the violation was not due to willful neglect, and that the request for VCAP assistance was made promptly at the discovery of the violation. TEB typically looks at the specific issue raised, and addresses it in the closing agreement. These agreements generally follow the model closing agreement specified in Section 7.6.2 of the Internal Revenue Manual, designed to protect bondholders from taxation of interest on these bonds. Ordinarily a closing agreement requires payment of a charge (a "closing agreement amount") to the IRS. There has been a steady increase in the use of the program, which TEB believes is attributable to a growing trust that the process will be fair and expeditious.

The IRS Data Book, 2006,<sup>18</sup> indicates that for 2006, plan sponsors entered into 60 voluntary compliance agreements. By contrast, approximately 500 returns were examined in audits in 2006. This suggests that this program could be a more efficient use of TE/GE staff resources in addressing compliance problems.

### C. Voluntary Compliance Initiatives in the Indian Tribal Government Division

---

<sup>18</sup> *IRS Data Book 2006*, Internal Revenue Service; Publication 55B (Washington DC, March 2007).

## Proposal for an Exempt Organizations Voluntary Compliance Program

In 2006, TE/GE launched the Tribal Evaluation of Filing and Accuracy Compliance Program (“TEFAC”), a voluntary compliance check program for the Tribal Governments.<sup>19</sup> The program, designed for Tribes to voluntarily conduct their own compliance checks, is not an enforcement action by TE/GE, but rather an effort designed to determine whether a tribal entity is adhering to record-keeping and information reporting requirements. Its goal is to highlight possible areas of non-compliance and indicate courses of remedial action by self-correction. The Tribe fills out an on-line request form to evaluate its filing and accuracy compliance and to qualify for the self-evaluation program. Once eligible, the Tribe completes the 8-page evaluation template (Form 13797), and submits it to TE/GE. The form lists areas of possible non-compliance, particularly in payroll areas, and asks for information on the corrective actions planned by the Tribe.

Voluntary compliance with filing obligations is a feature of this program; the Tribe must be current in all filing requirements within thirty days of application in order to participate. This program is a joint effort by TE/GE and the Tribal Governments towards achieving compliance with proper tax reporting. The ACT solicited market feedback regarding this program as part of this year’s report.

### D. Voluntary Compliance Initiatives in the Exempt Organization Division

The EO Division has never had a formal broad-based voluntary compliance program. Its voluntary compliance efforts have taken two forms: informal compliance opportunities, and several formal programs of limited duration, directed at specific issues. In the IRS’ view, these voluntary compliance programs have not been uniformly positive.<sup>20</sup> The number of organizations that have availed themselves of EO’s formal voluntary compliance programs has been disappointingly small.<sup>21</sup> The Service has interpreted this as a lack of interest in the nonprofit community. We believe, however, that this does not reflect lack of interest or, indeed, lack of need for a VCP but is due to other factors. The programs actually offered by EO have been narrow in scope and available

---

<sup>19</sup> Before 1993, IRS enforcement activities in the Indian Tribal Government (“ITG”) area were limited to resource-intensive IRS examinations of returns filed. In 1993 the IRS instituted the “TIP Program,” which was designed to increase voluntary compliance with tip income reporting. Although not strictly a voluntary compliance program, this initiative was designed to encourage taxpayer compliance, and minimize resource-intensive enforcement action. TIGTA’s latest report on the TIP Program indicates a rise in voluntary compliance with tip reporting, believed to be largely attributable to this program. *The Indian Tribal Governments Office’s Administration of the Tip Compliance Program for Its Customer Base Increased Voluntary Compliance*, Treasury Inspector General for Tax Administration, Reference Number 2006-10-131, September 8, 2006, <http://www.treas.gov/tigta/auditreports/2006reports/200610131fr.html>.

<sup>20</sup> See comments of Steven T. Miller, ABA Tax Section EO Committee Meeting (May 2002), 37 *Exempt Organization Tax Review* 41, 55 (2002).

<sup>21</sup> *Id.* In Ann. 2001-14, 2001-7 IRB 6438, the Service requested comments on potential voluntary compliance programs, but according to Mr. Miller, *supra* n.20, received few responses.

Proposal for an Exempt Organizations Voluntary Compliance Program to a limited subset of exempt organizations, suggesting a disconnect between what the regulated sector could correct through a VCP and what the Service has thus far offered. Moreover, the diverse nature and enormous size of the exempt organizations community, in contrast to other divisions within TE/GE, makes promoting such a program a challenge. Therefore, the success of any VCP should not be assessed by initial participation rates, since it may be some years before its benefits are widely accepted.

**Current EO Division Practice.** Although the EO Unit does not have a formal, ongoing voluntary compliance program, guidelines and procedures for EO Closing Agreements in section 4.75.25.1 of the Internal Revenue Manual (“IRM”) apply to voluntary taxpayer-initiated (walk-in) requests. These procedures provide that other IRS offices will forward requests for closing agreements to the appropriate Area Office for consideration, unless the Director, EO has identified the issue for referral to the Manager, EO Technical, or the circumstances otherwise suggest that this group should consider the request.

The IRM contains advisory guidelines that are intended to help reach uniform results in areas not expressly covered by regulations and court decisions.<sup>22</sup> EO personnel are advised to use closing agreements only to resolve matters that cannot be resolved through normal compliance processing procedures and to encourage future voluntary compliance. Further, the guidelines provide that a closing agreement is not appropriate when a taxpayer has engaged in flagrant or continuous acts compelling revocation or imposition of tax, unless the Service can reasonably assure future compliance. Significantly, the guidelines state not only that the Service will strive to bring a taxpayer subject to a closing agreement into full retroactive compliance, but that the Service also generally expects payment of 100% of the tax liabilities, interest, and penalties for all open tax years.

Practitioners report, however, that in many cases, especially those involving failure to file returns, the Service requires compliance only for three prior years. Additionally, the Service waives late filing penalties in close to 60% of the cases that involve first-time offenders.<sup>23</sup> This is consistent with a statement in the guidelines that the Service may consider more favorably a taxpayer voluntarily approaching the Service to resolve outstanding issues and agreeing to future voluntary compliance.

---

<sup>22</sup> For example, they state that closing agreements are not intended to circumvent the private foundation provisions of Chapter 42 of the Code; the excise taxes required under Sections 4911, 4912, 4955, 4958 excise taxes; or the abatement of first and second tier taxes in certain cases, as provided in Subchapter E of Chapter 42.

<sup>23</sup> Nina Olson, Taxpayer Advocate, in remarks to the Exempt Organizations Committee of the Tax Section of the American Bar Association in January 2007, reproduced in 56 *Exempt Organization Tax Review* 21, 48 (2007).

An exempt organization fearing revocation or taxation may voluntarily contact the Area Office to resolve outstanding issues by way of a closing agreement. However, the Service is not required to enter into a closing agreement. The organization must provide the Service with sufficient facts and documentation (and the Service may make sufficient examination or inquiry) to warrant acceptance of the agreement. EO personnel may discuss a closing agreement with an anonymous taxpayer; however, discussions may not proceed beyond the draft closing agreement stage without identification of the taxpayer.

An exempt organization that asks to enter into a closing agreement must (a) explain why a closing agreement is appropriate; (b) describe the advantage(s) to the taxpayer and indicate that the government will sustain no disadvantage(s) because of a closing agreement; (c) provide a detailed description of the method proposed for correcting the non-compliant activities; (d) describe each step of the correction method in narrative form, including specific information to support the suggested correction method; (e) explain how the taxpayer will achieve future compliance; and (f) describe proposed methodology to calculate any tax, interest and penalty. The Service is not required to negotiate a closing agreement during these discussions.<sup>24</sup>

By contrast, if an organization files a late return, the authority to waive late filing penalties resides in Ogden, Utah where all Forms 990 and 990-EZ are filed. Section 6652(c)(4) provides that the Service can waive a penalty for late filing of information returns if there is reasonable cause. IRS staff in Utah reported that they are generally flexible in finding there is reasonable cause if there is no prior history of late filing but they generally do not find there is reasonable cause for failure to file if an organization has previously failed to file.<sup>25</sup>

Currently, the IRS cannot maintain reliable data on the extent of nonfiling due to the exemption for organizations that fall below the filing threshold. Moreover, because unrepresented exempt organizations (or organizations represented by advisors who do not know they may safely contact the Service) may not call the Service, we do not know whether the informal voluntary compliance efforts that we describe here represent a large or small sample of the universe of organizations that are out of compliance and wish to correct their problems.

**Past EO Voluntary Compliance Efforts.** In the last 15 years, EO has offered three narrowly drawn and time-limited voluntary compliance programs. For various reasons,

---

<sup>24</sup> I.R.M. 4.75.25.13.

<sup>25</sup> In 2005, according to the Taxpayer Advocate, the Service abated approximately 56% of the delinquent filing penalties that it assessed, amounting to some 59% of the dollars involved. Nina Olson, Taxpayer Advocate, in remarks to the Exempt Organizations Committee of the Tax Section of the American Bar Association in January 2007, reproduced in 56 *Exempt Organization Tax Review* 21, 48 (2007).

none of them produced results commensurate with the effort that went into designing them.

*Alien Withholding.* The most detailed program began in early 2001, when EO issued Revenue Procedure 2001-20, 2001-1 CB 738, with detailed procedures to enable colleges and universities to request relief for failure to properly withhold income and employment taxes from payments to alien individuals. The program was effective from February 26, 2001 to February 28, 2002. We understand that approximately twelve organizations took advantage of this program. The participation may have been limited because of timing: by the time the Service issued Rev. Proc. 2001-20, most organizations that had withholding problems had already corrected them.

Nonetheless, the design of the program is instructive. Under this program, organizations that requested consideration agreed to (1) identify those areas in which they were not in compliance with tax, withholding, and reporting obligations on payments to alien individuals; (2) compute and pay any tax and interest due; and (3) institute procedures and policies which would assure compliance in the future with the organization's tax, withholding, and reporting obligations. In return, they received assurance that their proposed procedures and policies relating to tax, withholding, and reporting obligations applicable to alien individuals were acceptable to the Service, and the Service "generally" would not impose penalties for identified underpayments or deficiencies, if the liability was due to reasonable cause as defined in the Revenue Procedure.

The program was available to private colleges and universities and state colleges and universities and their charitable affiliates which were not under audit on the date of the Revenue Procedure or prior to coming forward under the program. The Revenue Procedure included a list of the specific defects covered by the program. They included failure to withhold or pay the correct amount of social security and Medicare excise taxes imposed on employers and employees with respect to wages paid to alien individuals (IRC §§ 3101, 3111, 3402); failure to withhold or pay the correct amount of income taxes on scholarships, fellowships and grants, compensation for independent personal services, and royalties or other types of taxable income paid to nonresident alien individuals (IRC §§1441-1464); and failure to report the correct amount of any or all of the taxes listed above (IRC §§1441-1464 and 6011).

Participants in the program were required to submit a letter to TE/GE with detailed information about the current administrative procedures that the organization used to determine tax, withholding, and reporting obligations regarding payments to alien individuals. They were required to describe the defects in their procedures for payments to alien individuals, how and why the defects occurred, the years affected by such defects, the number of alien individuals affected, and how the number was determined. In addition, they were required to calculate the total amount of taxes they failed to withhold, pay and/or report for tax periods open for assessment or collection.

Finally, participating organizations were required to provide a detailed description of how they intended to correct the defects, both for existing errors and for ongoing compliance. However, an organization's participation in the program did not preclude the Service from commencing an employment tax audit or from asserting that individuals treated as independent contractors were employees.<sup>26</sup>

*Net Revenue Stream Voluntary Compliance Program.* Past voluntary compliance programs in EO were not limited to filing deficiencies. In 1992, the Service announced a voluntary compliance program that addressed the fundamental Section 501(c)(3) issue of private inurement. This program, described in Announcement 92-70, 1992-19 IRB 89, focused on hospitals that had entered into transactions with their medical staff that allowed the staff to share in the net revenues of the hospitals. According to the Announcement, a number of hospitals described in section 501(c)(3) formed joint ventures with members of their medical staff and sold to the joint venture the gross or net revenue stream derived from the operation of an existing hospital department or service for a defined period of time.

A hospital entering into such a transaction jeopardized its tax exempt status under section 501(c)(3) for at least three reasons. First, the transaction caused the hospital's net earnings to inure to the benefit of private individuals (the physician investors). Second, the private benefit stemming from such a transaction could not be considered incidental to the public benefits received. Third, such a transaction, since it involved sale of a revenue stream from a hospital activity to referring physician-investors, may violate federal law.<sup>27</sup>

Under the program, hospitals that had entered into partnerships or joint ventures with staff or related physicians were permitted to terminate the arrangement without loss of their exempt status by requesting to enter a closing agreement with the IRS before September 1, 1992. After that date, the transactions would be treated by the IRS as subject to the usual procedures governing tax consequences, including revocation of exempt status.

We understand that approximately ten organizations participated in the program. The limited participation rate in this VCP, too, may also have been a result of the time required to design and implement it.

---

<sup>26</sup> Participating organizations were also required to provide copies of workpapers or schedules that clearly explained the organization's calculation of its correct tax liability regarding payments to alien individuals; copies of the original Forms 941, 945, 1042, if any, as filed that relate to these calculations; and copies of Forms 8233, 1001, W-BEN, W-9, or sufficient information to support tax treaty claims.

<sup>27</sup> See G.C.M. 39862 (Nov. 21, 1991).

Proposal for an Exempt Organizations Voluntary Compliance Program  
Section 527 Non-Filer Initiative. In Notice 2002-34, 2002-1 C.B. 990 (May 2, 2002), the Service announced a voluntary compliance program for Section 527 political organizations that had failed to file required forms.

Strict new filing requirements with stiff penalties had taken effect on July 1, 2000. Section 527 organizations are required to file Form 8871 electronically and in hard copy within 24 hours of their formation. Until Form 8871 is filed, the organization's income is subject to tax. Additionally, Section 527 organizations must file Form 8872 to report contributions and expenditures. Failure to file results in taxation of contributions and expenditures not disclosed at the highest corporate income tax rate (currently 35%). Section 527 organizations must also file Form 1120-POL or 990 and are subject to penalties for failure to file.

Confusion existed regarding filing requirements and many organizations failed to file or filed incomplete forms. In response, the IRS announced it would not assert tax, penalty or interest if a Section 527 organization filed or corrected a form by July 15, 2002. The program applied to Forms 8871, 8872, 1120-POL, 990, and 990-EZ if the filing date for the form was before July 15, 2002. It did not apply to a Form 1120-POL that was required to be filed under rules in effect before July 1, 2000.

The Service indicated that the purpose of legislation was to have maximum disclosure regarding the formation of Section 527 organizations and the contributions received by such organizations. Filing by July 15, 2002 would provide disclosure before the 2002 election and, thus, the program furthered the purpose of the legislation.

We understand that few eligible organizations participated in this program for several reasons. First, the IRS was not in regular communication with the election law practitioners for whom compliance with these changes was a central role, and outreach to that community proved difficult. Then, in November, 2002, Congress further amended the reporting provisions under Section 527 to reduce the range of organizations required to make filings, and state or local political groups that make duplicative disclosures under comparable state laws were relieved from filing Form 8872. Also, the law change gave the IRS power to waive taxes and penalties for cases where failure was due to reasonable cause and not willful neglect. Since that time, filing problems have been significantly reduced as the system became more rational and political campaign financial advisors became accustomed to how the Section 527 regime functions, over several election cycles.

#### E. What We Learned

From our review of past and present voluntary compliance programs in the TE/GE Division, we draw three key principles from which our recommendations flow.

First, an effective VCP addresses real needs of both the regulators and the regulated community with a clearly defined and focused path to a solution that serves both sides of the transaction. TEB's VCP works, for example, because it serves the tax policy and law enforcement goals of the Service and also because it answers the needs of the regulated community for a way to repair errors without putting the tax-exempt status of bonds (and, thus, not only investors but the market itself) at risk.

Second, timing is all-important. A program that takes too long to develop and promulgate may reach the regulated community after members of that community have already dealt with the problem, whether well or badly, and moved on.

Third, it is essential to have both a vigorous marketing/outreach effort and patience with an initial slow participation rate. It takes time for the regulated sector to learn about a VCP opportunity, particularly an opportunity that may be most useful for organizations without professional advisors or with which the IRS is not in regular communication. And it takes still more time for these organizations to assure themselves that the benefits of participation, given their experience of relatively low levels of enforcement attention, outweigh their fears of the consequences of coming forward.

#### **4. Framework for an EO VCP**

Before we turn to our specific recommendations for an EO VCP, we suggest a set of conceptual and practical principles that we believe will assist EO in designing and implementing a VCP. We have based our own recommendations on these principles. Because the design and the implementation of a VCP are two very different tasks, we offer two separate sets of principles.

##### **A. Designing an EO VCP**

Creating an effective VCP for exempt organizations will require the IRS to plan carefully and incorporate the lessons learned from previous programs -- both successful and less than successful, for both charities and for other tax-exempt organizations. In particular, the IRS must be sensitive to the incentives that induce organizations to participate in these programs, and how they may differ for exempt organizations in comparison to other tax-exempt entities to which such programs have been offered. The IRS must also devote careful planning to meet what will be the greatest obstacle to the success of any VCP for exempt organizations on a broad scale: marketing the program to its intended users. The extraordinarily diverse character of charitable exempt organizations and their disproportionate population of smaller organizations without access to professional assistance will require sustained outreach through many channels in order to promote the program effectively.

In order to *design* a successful Voluntary Compliance Program, the IRS should:

- **Take into account the lessons learned** from successful and unsuccessful VCPs in other areas of TE/GE, but note the differences as well. For example, EO returns are public while these others are mostly not; EOs often are represented by volunteers while others almost always have professional assistance, and EOs are most often small organizations while others are often larger.
- **Understand the incentives** and disincentives for participation in a VCP that would operate in an EO program (including the contrasting impetus provided by third party interests in other VCPs and the depressing effect caused by limited IRS enforcement resources), and build in positive and negative inducements wherever possible.
- **Be mindful of audit and enforcement priorities** in EO, and address issues, define eligibility, and design a process that will provide a less costly mechanism to resolve problems but will not undermine those priorities (by, for example, requiring an extension of the statute of limitations as a condition for participation).
- In order to conserve resources efficiently and measure success effectively, **start with a relatively straightforward program** with predictable outcomes and fewer exercises in reviewer discretion, expanding to more complex and fact-specific issues later.
- If not already measured, **create a baseline of information** about noncompliance on the issue that is the subject of the VCP, and track both participation rates and outcomes at regular intervals once the VCP is under way.
- **Commit significant resources over a sustained period to marketing** such a program to the EO community in general and to the targeted population in particular.

## B. Operating an EO VCP

Operating an effective EO VCP will require the IRS to focus on issues that will enhance – or may threaten to impede – the efficiency and consistency of the process. With limited resources with which to offer programs and provide services, the smaller organizations that would benefit from a VCP will be disinclined to participate if the process is not simple and inexpensive. Likewise, with limited resources to dedicate to the program, the IRS itself will be unable to sustain its commitment for the period necessary to produce meaningful participation levels if the VCP is too complex or staff-intensive. Finally, neither the exempt organization community nor the public is likely to

respond favorably to a VCP that produces – or is perceived to produce – inconsistent outcomes for similarly situated organizations or comparable compliance problems.

In order to *operate* a successful VCP, the IRS should:

- For efficiency, **centralize the process** in a single geographical location, and review multi-year delinquencies/noncompliance as a single application for relief.
- **Promote consistency by clear written eligibility standards** (e.g., defining "reasonable cause" for the waiver of penalties; setting a realistic period of retrospective noncompliance that must be remedied in order to participate, etc.) and user-friendly written instructions that are articulated in terms that can be easily applied by the greatest number of IRS staff and understood by persons without access to professional guidance.
- **Provide a mechanism for anonymous communication** at the threshold of the process, without making commitments as to outcome until the organization is identified.
- **Consider waiving user fees for smaller organizations**, perhaps through a sliding scale that encourages smaller organizations to participate.
- **Document resolutions** through mechanisms that provide finality but also are expeditious and do not require more than simplified closing agreements.
- **Provide a centralized point of review of challenged determinations**, staffed by personnel with sufficient experience and expertise to exercise judgment and review exercises of discretion by others, and provide for expedited disposition of those reviews.

With these principles in mind, we now describe the specific VCP that we recommend to the Service for the EO Division.

### **5. Recommendation: A Voluntary Compliance Program For Exempt Organizations**

We believe that the EO Division should work toward adopting a broad-based VCP. Ultimately, the VCP should offer a single point of entry for the resolution of most exempt organization issues that are not already under audit, in court or under advisement within the IRS, including inurement, private benefit, electioneering, excessive lobbying and loss of or failure to qualify for public charity status. We appreciate that this will entail dealing with complex issues and with matters that involve significant improprieties, but encouraging exempt organizations to identify and bring such matters to the attention of the IRS for resolution is a highest and best use of the EO Division's limited resources.

While a comprehensive program would in our view be salutary from the standpoint of both the IRS and the regulated community, we appreciate the desirability of building a VCP in stages to allow the EO Division to develop practical experience in administering the program without being overwhelmed by either the magnitude or complexity of a broad scale program, and to assure that matters can be resolved promptly. Accordingly, we suggest approaching the program in a series of phases with the ultimate goal of developing a comprehensive EO Division VCP. To that end, we suggest an initial transitional program, designed specifically in response to the incentive that Congress created – that is, loss of tax-exempt status for three consecutive failures to file – leading to a long-term program addressing the same issues.

#### A. Transitional VCP

Under new Section 6033(j), an exempt organization that is otherwise required to file an annual report or notice with the Service will lose its tax-exempt status if it fails to file the required notice or return for three consecutive years. As the Joint Committee on Taxation report puts it, “A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice.”<sup>28</sup> Because this statute is effective for notices and returns for tax years beginning after 2006, the first year in which “the third required information return or notice” will be due, and potentially missing, is the year in which returns for years beginning in 2009 are due – that is, in 2010.

This looming deadline creates a powerful short-term incentive for exempt organizations to bring their reporting failures into compliance. It also creates an opportunity for the Service to offer a time-limited and transitional VCP for *all* exempt organizations with missing returns, while it develops an ongoing VCP with eligibility criteria along the lines that we suggest below. The key features of this transitional VCP are:

- **Eligibility:** Every exempt organization that is obligated, under IRC 6033, to file a return or a notice and that is not under examination, in Appeals, or in court on a tax matter involving a year for which the organization proposes to file a return or notice, is eligible to participate in this VCP.
- **Filing obligation:** Form 990, 990-EZ, 990-PF, or 990-T, as applicable, for the three most recent tax years, together with Forms 941, 1099, and W-2, if

---

<sup>28</sup> Joint Committee on Taxation, Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06) August 3, 2006, page 326.

applicable, for any period during the three most recent tax years for which such returns were otherwise due.<sup>29</sup>

- **Payment:** The organization must pay all taxes due with the return or notice, with applicable interest. For example, if the organization files a 990-T to report income from an unrelated business activity, it must pay all tax due on that income along with all interest due the Service on the unpaid tax. Similarly, if the organization had employees but failed to timely file Form W-2 and remit applicable payroll taxes, it must remit those taxes together with applicable interest.
- **Penalties:** No penalties would be assessed for filing delinquencies, although no relief would be provided for any other issues, including any problems reflected in the delinquent returns filed to participate in the program. For this limited time, the IRS would not assess the late filing penalties that it would otherwise be entitled to assess for failure to timely file the returns covered by this VCP.<sup>30</sup> We make this recommendation because we believe that the Service and the public derive a greater benefit from access to the information reported on these returns and notices and (importantly) from bringing these non-filers back into long-term compliance, going forward, than they would gain from assessing late filing penalties.
- **User fee:** A sliding scale would apply, with no fee for participating organizations with assets and revenues under \$1 million in each of the three years for which delinquent returns are filed. We make this recommendation because we believe it is in the best interests of the Service and the public to avoid disincentives for small organizations to participate in this transitional VCP.
- **Time frame:** We strongly recommend commencing the transitional phase of this program as soon as possible, with an end date of December 31, 2010. The Pension Protection Act provides that automatic revocation will be imposed for a failure to file three consecutive returns for any reporting period beginning after 2006. Therefore, automatic revocations for organizations now "outside the system" will begin on January 1, 2010 and be completed on December 31, 2010 (although automatic revocations will continue thereafter for exempt organizations that subsequently fail to file for three consecutive years). This means it is essential to begin *now* to implement this transitional VCP.

---

<sup>29</sup> Unlike our recommendation for an ongoing program, there appears to be no need for anonymity in the initial contact with the IRS. Since participating organizations would not be required to show "reasonable cause" for their noncompliance, those preliminary discussions should be unnecessary. This program does not cover nonfilers of Form 990N, the "e-postcard" filing, because no financial penalties are imposed for nonfiling; the penalty is revocation of exempt status after three consecutive years of non-filing.

<sup>30</sup> IRM Section 20.1.1.3.2.2, Administrative Waiver (8/20/1998).

In our description of the ongoing VCP, below, we recommend a vigorous outreach effort and a staffing level that reflects the importance of this project. Those recommendations are key here as well. For this transitional VCP, however, we believe that evaluation is an equally essential component. The Service can use this transitional program to find out what outreach vehicles generate the most responses, what staffing patterns are necessary, and the like. Since we view this transitional program as a bridge between the current lack of a formal VCP and the proposed structured VCP, we believe that the Service can learn much that is useful along the way.

## B. Ongoing VCP

Building on what the Service learns during the transitional phase, a formal, structured, and open-ended EO VCP should address the same filing problems as our recommended transitional VCP, but with a higher entry threshold. This ongoing VCP would address (a) failure to file, or failure to file complete and accurate, Forms 990 (including 990-EZ), 990-T, and 990-PF, and (b) failure to file, or failure to file complete and accurate, Forms W-2, 941, and 1099.

We believe that the ongoing VCP should not be limited to filing problems. We believe it is important to offer a wider VCP, allowing exempt organizations to bring other non-compliance matters to the Service for orderly and consistent resolution. We begin with filing problems (in the firm belief that the program should not end with them) for three principal reasons. First, we believe they will be relatively easy to administer. The violations involve clear legal and regulatory principles, allowing for implementation of specific corrective measures without the need for significant discretion. Second, the filing of tax returns (including employment tax returns) is fundamental to compliance and transparency, in terms of both IRS enforcement and the public oversight that is so critical in this area. Finally, the Service can benefit from its experience in administering the transitional VCP, since this open-ended program addresses many of the same issues.

**Qualification for the EO VCP.** One issue for an ongoing VCP for non-filers is whether any exempt organization, regardless of the scienter involved in its failure to file and regardless of other improprieties reflected in the returns, should be eligible for the EO VCP. We hope that by the time the EO VCP evolves into a comprehensive program, even organizations with other serious compliance issues would be able to participate. It seems to us that given the expense of pursuing wrongdoers, allowing them to present themselves voluntarily to resolve their transgressions is an efficient use of limited IRS resources, freeing up additional resources to pursue those who do not appear voluntarily. On the other hand, we appreciate that including such serious cases in the initial phases of the EO VCP will complicate the administration of the program, may implicate complex legal and regulatory principles, and may require significant discretion. We also are mindful that many of the other voluntary compliance programs in TE/GE exclude egregious situations, and others are limited to cases where there is “reasonable cause.”

With regard to nonfilers of information returns, we believe the default should be an “open door policy” with certain limited exceptions. Specifically, we recommend making the EO VCP available to an exempt organization so long as:

- the organization’s failure to file the return(s) was due to reasonable cause;<sup>31</sup>
- the late return(s) do not show that the exempt organization: is subject to the excise tax under Sections 4941, 4942, 4943, 4944 or 4945 for self-dealing, failure to distribute income, excess business holdings, investments that jeopardize charitable purposes and taxable expenditures; is subject to the excise tax under Section 4912 for excess lobbying expenditures that result in loss of exemption under Section 501(c)(3); is subject to the excise tax under Section 4955 for participation or intervention in a political campaign on behalf of or in opposition to a candidate for public office; was involved in an “excess benefit transaction” that could result in the imposition of the excise tax under Section 4958 on a disqualified person or organization manager; is subject to the excise tax under Section 4965 related to prohibited tax shelter transactions; is subject to the excise tax under Sections 4966 or 4967 related to certain prohibited activities by donor advised funds; is subject to the excise tax under Section 170(f)(10) for premiums paid on certain personal benefit contracts; is subject to the termination tax under Section 507(c); or is subject to revocation pursuant to Section 6033(j) for three consecutive years of failure to file; or
- the exempt organization is not under examination by the IRS, in Appeals or in court with respect to any issue within the jurisdiction of the IRS.

With regard to W-2 and 1099 nonfilers, we believe that organizations should be eligible if their W-2/1099 issues are not subject to other extant programs within the IRS, such as the Classification Settlement Program. Potential participants should be subject to qualifications similar to those that we have recommended in connection with Forms 990, 990-T, and 990-PF.

Including W-2/1099 nonfiling in the ongoing EO VCP meets two hallmarks of other VCPs in TE/GE: the issues directly affect the interests of third parties (here, employees and independent contractors); and organizations are more highly motivated to correct promptly their failures in this area (here, to preclude or rectify tax filing problems for their employees and contractors).

---

<sup>31</sup> We believe that the eligibility standard that Rev. Proc. 2006-27 outlines for the EPCRS program – no abusive tax avoidance transactions, no egregious failures, no diversion or misuse of plan assets – would be preferable as a matter of policy, since it would permit more organizations to use the VCP to return to compliance. We recognize that Congress’ adoption of a reasonable cause standard in new IRC 6033(j) with regard to the consequences of repeated failures to file exempt organization returns may limit the Service’s flexibility in this area. Nonetheless, we urge the Service to construe “reasonable cause” liberally in order to encourage participation in this VCP.

We understand that while the Small Business/Self-Employed Division of the IRS is responsible for employment tax policy, TE/GE is responsible for administering the employment taxation of tax-exempt entities and governmental employers. Our preliminary analysis and discussions suggest that a pilot program in EO that allows exempt organizations to resolve issues related to failure to file, or failure to file complete and accurate, Forms W-2 and 1099 does not implicate tax policy and, if successful, could serve as a model for other areas within the IRS.

***Procedure.*** We offer specific procedural recommendations, based on what we have learned from other voluntary compliance programs within the TE/GE Division and from our inquiries in preparing this report.

Establishment of an EO VCP Office. As with other ongoing VCPs in TE/GE, we think it is critical to have a dedicated EO VCP office. This will assure the consistent and even-handed operation of the program. It also will allow for securing the experience important to the evolution toward a comprehensive EO VCP. To maximize the likelihood the program will be successful, we believe the head of the EO VCP should be a person with significant experience in the EO Division. This person should receive substantial training from, and have continuing access to, attorneys in the Rulings & Agreements group and in the office of the Associate Chief Counsel for TE/GE. Similarly, the Tax Law Specialists administering the EO VCP under the direction of the head of the VCP Office should have solid experience in the EO area. Assuring a sufficiently high level of personnel in the EO VCP office and their continuing access to internal expertise is crucial, not only in the formative stages of the program, but also as it evolves to handle more challenging issues. This also sends a signal, both internally and externally, that the VCP has institutional support.

Confidential Contacts. As is common with other ongoing VCPs in TE/GE, we think it is important for exempt organizations and their legal/accounting representatives to be able to contact the EO VCP office on a confidential basis to discuss the possibility of the organization's participation in the EO VCP. Our survey and conversations with leading EO practitioners indicate that there may be substantial hesitancy to use a VCP, at least in its formative stages, if preliminary confidential contacts are not permitted. This is particularly true for those practitioners who currently are able to access representatives of the IRS on an initially confidential basis. Such confidential contacts could include a proffer by the organization or its representative of specific facts and a conclusion by the EO VCP Office of the likely outcome before the organization formally submits a request to participate in the EO VCP.<sup>32</sup>

---

<sup>32</sup> Our proposed transitional VCP did not recommend confidential contacts because that program does not require a showing of reasonable cause for failure to file. Here, confidentiality enables organizations to "test the waters" regarding the Service's likely view of whether the failure in question was in fact due to reasonable cause. Of course, informal discussions are not binding either on the organization or on the

Conditions for Participation in the EO VCP. To participate in the EO VCP, the exempt organization must:

- a. file any delinquent Forms 990/990-EZ/990-PF and Form 990-T for the prior three years, and correct any forms W2 or 1099 for which relief is sought;
- b. simultaneously file any ancillary returns due, such as Form 4720 for payment of the Section 4911 tax on excess lobbying expenditures by public charities that have elected to be subject to Section 501(h), Form 1120-POL in the case of an exempt organization treated as having political organization taxable income under Section 527(f)(1), or Form 926 in the case of transfers of property to a foreign corporation;
- c. include payment for any taxes shown as due on those returns (e.g., Section 4940 tax on investment income, unrelated trade or business taxes); and
- d. agree to maintain books and records going forward sufficient to allow it to continue to file its forms on a current basis.

Request to Participate in the VCP. Similarly with other VCPs in TE/GE, the EO Division should develop a Notice of Election and Statement to be filed by the exempt organization in which it elects to participate in the VCP. The document should include:

- a. name, address, telephone number, fax number, and employer identification number;
- b. contact person (at organization or an authorized representative, and in the latter case Form 2848, Power of Attorney must be submitted with the Statement), with name, address, telephone number and fax number;
- c. the unfiled return(s) with all taxes shown as due;
- d. how it was discovered that the return(s) should have been filed but was(were) not and why that constitutes reasonable cause;
- e. representations under penalties of perjury that the exempt organization is not under examination by the IRS, in Appeals or in court with respect to any issue relating to the jurisdiction of the IRS, the delinquent return(s) filed with the Statement is(are) complete and accurate and the exempt organization agrees to maintain books and records going forward sufficient to allow it to continue to file its form(s) on a current basis;

---

Service; relief would be available only after the organization formally applies for participation in the VCP, as described above, and then only if the facts submitted to the Service justify relief.

- f. in the case of delinquent Forms 990-T and 990-PF, the exempt organization would agree to waive all defenses to the assessment and collection of penalties for failure to file estimated taxes;
- g. in the case of late tax payments, the exempt organization would agree to waive all defenses to the assessment and collection of statutory interest;
- h. the Statement would make clear that if the delinquent return(s) is(are) not complete and accurate, the exempt organization may be subject to IRS audits and penalties that could cover more than the three years potentially at issue; and
- i. where appropriate, the Statement would include a waiver of the statute of limitations by the exempt organization.

Benefits to the EO. Exempt organizations participating in the EO VCP will not be subject to revocation of exemption based solely on the failure to file or other noncompliance specifically intended to be addressed in the program.<sup>33</sup> Exempt organizations filing delinquent returns will not be subject to penalties for late filing, except that penalties may apply where the EO is unable to show that its failure to file was not egregious, and the organization will still be liable for failure to file and pay estimated taxes in applicable cases involving Forms 990-T and 990-PF. (All late tax payments will be subject to assessment of statutory interest.)

Closing Agreement. We believe that exempt organizations participating in the EO VCP should be permitted to request a closing agreement or other document confirming the outcome and that the proposed initial phases of this initiative lend themselves to a simple form of documentation.

User Fees. We are not opposed to the imposition of reasonable user fees based on the size of the organization.<sup>34</sup> On the other hand, the history of other VCP programs in TE/GE suggests that exempt organizations often are hesitant to participate in new VCPs. The desirability of not further discouraging participation in the EO VCP's formative years suggests limiting those user fees, at least in the beginning period of the program. Accordingly, we recommend not imposing any user fee in the initial phases of the EO VCP initiative on an exempt organization whose Total Revenue (Part I, line 12 of

---

<sup>33</sup> By contrast, the remedy of revocation of exempt status would continue to be available for all other issues, including violations of law that are revealed in filings or submissions made by exempt organizations in the course of participation in the VCP. Serious compliance problems for which the IRS determines that it must preserve the possible penalty of revocation may not be appropriate, by their nature, for inclusion in a VCP. However, that remedy cannot be excluded for issues outside the scope of the program that are revealed in the course of participating in the VCP.

<sup>34</sup> Our approach to user fees for participation in the proposed ongoing VCP is intentionally different from our proposed transitional VCP.

## Proposal for an Exempt Organizations Voluntary Compliance Program

the Form 990 and Form 990-PF) and Net Assets (Part IV, line 74 of the Form 990 and Part III, line 31 of the Form 990-PF) are equal to or less than \$1 million at the end of the year as to which the delinquent return relates. The Service is best placed to determine appropriate user fees for organizations that exceed these levels; however, we recommend a sliding scale that encourages participation by smaller organizations.

Publicizing Availability of the EO VCP. The IRS should assure that exempt organizations and their representatives are made aware of the EO VCP initiative once it is implemented. We strongly recommend a multi-prong outreach approach, starting with the publication of a Revenue Procedure and continuing with an announcement on the TE/GE web pages for the varieties of exempt organizations, a prominently featured article in the email sent to those on the IRS EO listserv, announcements in speeches by IRS representatives, inclusion in IRS publications, inclusion of prominent reference on the instructions for the Forms 990, 990-EZ, 990-PF and 990-T, and in any notices that are otherwise sent to exempt organizations.

However, promotion of this program through the official channels described above will likely not be sufficient to induce participation by a meaningful number of non-filing exempt organizations. The organizations for which the non-filing aspect of the program is intended, especially during the transitional phase, are by their nature not in regular communication with the IRS. Those organizations, many of them small with volunteer staffing, must be reached by other means. We strongly recommend that special efforts be taken to attract media attention for this program beyond the professional outlets, using the deadlines created for the expiration of the transitional phase to create exposure for this problem and the IRS' solution to it.

Proposal for an Exempt Organizations Voluntary Compliance Program  
**APPENDIX 1: Persons Interviewed for This Report**

The ACT spoke, on a confidential basis, with a number of lawyers and accountants familiar with formal and informal voluntary compliance procedures for exempt organizations. We appreciate the comments of our ACT colleagues, who made their voluntary compliance expertise available to us as well. In addition, we are grateful to the Service for making the following employees available to us for interviews, and to each of the IRS employees (listed in alphabetical order) for their generosity with time and information.

Robert Choi, Director, EO Rulings and Agreements

David Fish, Acting Manager, Technical Guidance and Quality Assurance, EO Rulings and Agreements

Marvin Friedlander, Manager / Technical, EO Rulings and Agreements

Clifford Gannett, Director, Tax-Exempt Bonds

Joseph H. Grant, Director, Employee Plans

Vicki Hansen, Area Manager, EO Compliance Area (EO Examinations)

Joyce Kahn, Manager, Voluntary Compliance, EP Rulings & Agreements

Lois Lerner, Director, Exempt Organizations

Catherine E. Livingston, Assistant Chief Counsel, TE/GE

Peter Lorenzetti, Area Manager Northeast, EO Examinations

Stephen Macchio, Manager, Processing Center Programs, TE/GE Customer Account Services, and various members of his staff

Rod McArthur, Program Manager, Employment Tax Policy (SBSE)

Steven T. Miller, Commissioner, TE/GE

Theresa Pattara, Project Manager, PPA & Form 990 Redesign (EO)

Marsha Ramirez, Director, EO Examinations

Lisa Schultz, Senior EO Mandatory Reviewer (EO Examinations)

Proposal for an Exempt Organizations Voluntary Compliance Program

Roberta Zarin, Director of Education and Outreach, (EO)

**Articles from Various Tax and General Publications:**

ABA Committee on Exempt Organizations, "Edited Transcript of the May 10, 2002, ABA Tax Section EO Committee Meeting," 37 Exempt Organization Tax Review 41, July 2002

Bennett, Alison, "IRS Unveils Sweeping Shelter Settlement Covering 21 Abusive Deals, 4,000 Taxpayers," Daily Tax Report Website, No. 208, ISSN 1522-8800, October 28, 2005

BNA. "The Development of Voluntary and Audit Correction Mechanisms," BNA Tax Management Income Tax Portfolio, 375-1<sup>st</sup>, February 20, 2007

Cowart, David T., Gilchrist & Jenkins, "Self-Correction Under EPCRS: Counseling Clients in an Evolving Area," American Bar Association: Section of Taxation, 2004 Midyear Meeting, Kissimmee, Florida, January 30, 2004

McGrory, Melissa K., and Theodore M. Mitchell, "Basic Law of Pensions, Welfare Plans, and Deferred Compensation: \*1133 The Employee Plans Compliance Resolution System," American Law Institute: American Bar Association Continuing Legal Education, SK012 ALI-ABA 1133, July 12-16, 2004

Purcell, Thomas J. III, "AICPA Recommends Steps to Improve Nonprofits' Filing Compliance," 2006 Tax Notes Today 161-43

Reish, C. Frederick, Bruce L. Ashton, and Nicholas J. White, "Compensation and Benefits: \*162 EPCRS Streamlined to Make Voluntary Correction Generally More Attractive to Small Businesses," 99 Journal of Taxation 162, RIA; September 2003

Schwinn, Elizabeth, "IRS Takes a Tougher Stance: The Tax Agency's New Approach Sparks Concern among Charities," Chronicle of Philanthropy, October 12, 2006

Siske, Roger C., "Annual Fall Employee Benefits Law and Practice Update: The New and Improved IRS Voluntary Compliance Program," American Law Institute: American Bar Association Continuing Legal Education, VMF1110 ALI-ABA 85, November 10, 2004

Stokeld, Fred, "IRS Official Promotes Exempt Bond Voluntary Compliance Program during Phone Forum," 2005 Tax Notes Today 231-4, December 2, 2005

Proposal for an Exempt Organizations Voluntary Compliance Program

Stokeld, Fred, "IRS Officials Tout Correction Options for Retirement Plan Sponsors," 2006 Tax Notes Today 114-6, June 14, 2006

Tax Analysts. "IRS Requests Comments on Closing Agreement Procedures," 2007 Tax Notes Today 19-4, January 29, 2007

**Articles from the IRS Website:**

"Common Procedural Errors in VCP Applications," Internal Revenue Website, view date: August 6, 2006

"Correcting Plan Errors," Internal Revenue Service Website, view date: August 3, 2006

"Educational Products," Internal Revenue Service Website, view date: January 29, 2007

"FAQ's Regarding the Self-Correction Program (SCP)," Internal Revenue Service Website, view date: August 6, 2006

"FAQ's Regarding the Voluntary Correction Program (VCP)," Internal Revenue Service Website, view date: August 6, 2006

"How to Contact ITG," Internal Revenue Service Website, view date: January 29, 2007

"Information for the Tax Exempt Bond Community," Internal Revenue Service Website, view date: January 12, 2007

"IRS Settlement Initiative: Employees at Foreign Embassies, Consular Offices and International Organizations in the U.S.," Internal Revenue Service Website, view date: February 13, 2007

"Offshore Credit Card Program (OCCP)," Internal Revenue Service Website, view date: August 7, 2006

"Offshore Tax-Avoidance Schemes and IRS Compliance Efforts," Internal Revenue Service Website, view date: August 7, 2006

"Privacy Impact Assessment-Offshore Credit Card Program (OCCP)," Internal Revenue Service Website, view date: August 7, 2006

"Retirement Plan Correction Programs-Frequently Asked Questions," Internal Revenue Service Website, view date: August 6, 2006

“Tax Exempt & Government Entities Division At-a-Glance,” Internal Revenue Service Website, view date: January 11, 2007

“Tax Exempt Bonds Alternative Dispute Resolution Programs,” Internal Revenue Service Website, view date: January 12, 2007

“Tax Exempt Bonds Alternative Dispute Resolution Programs,” Internal Revenue Service Website, view date: January 12, 2007

“Tax Information for Indian Tribal Governments: Enhancing Federal Tax Compliance,” Internal Revenue Service Website, view date: January 29, 2007

“Tax Information for Retirement Plans Community,” Internal revenue Service Website, view date: January 30, 2007

“Ten Reasons to Identify and Correct Mistakes in your Retirement Plan Operations,” Internal Revenue Service Website, view date: August 3, 2006

“Top Ten Failures Found in Voluntary Correction Program,” Internal Revenue Service Website, view date: August 3, 2006

EO Reporting Requirements, “Can Penalties for Filing Form 990 Late be Abated?” Internal Revenue Service Website, view date: January 10, 2007

EO Reporting Requirements, “What Happens if my Form 990 is Filed Late?” Internal Revenue Service Website, view date: January 10, 2007

EO Reporting Requirements, “What Happens if my Form 990 is Incomplete?” Internal Revenue Service Website, view date: January 10, 2007

### **IRS News Releases and Announcements:**

Announcement 92-70, April 21, 1992, “Offer to Resolve Tax Exemption Issues Arising from Gross or Net Revenue Stream Joint Ventures of Hospitals”

Announcement 2001-14, Exempt Organizations, I.R.B., 2001-7, February 12, 2001, “Request for Ideas for Exempt Organizations Plain-Language Publications and Voluntary Compliance Programs”

Announcement 2001-97, October 1, 2001, “Foundations Status of Certain Organizations”

Proposal for an Exempt Organizations Voluntary Compliance Program

Announcement 2003-36, January 2003, "Tax Exempt Bond Mediation Dispute Resolution Pilot Program"

Announcement 2006-95, November 17, 2006, "Settlement Initiative for Employees at Foreign Embassies, Foreign Consular Offices and International Organizations in the United States"

Announcement 2007-18, February 26, 2007, "Compliance Resolution Program for Employees Other Than Corporate Insiders for Additional 2006 Taxes Arising under § 409A Due to the Exercise of Stock Rights"

IR-2002-57, May 2, 2002, "IRS Offers Opportunity for 527 Groups to Comply by July 15"

IR-2003-5, Jan. 14, 2003, "IRS Unveils Offshore Voluntary Compliance Initiative; Chance for 'Credit-Card Abusers' to Clear Up Their Tax Liabilities"

IR-2003-35, March 17, 2003, "Offshore Voluntary Compliance Initiative has Month To Go; People Need to Apply Directly to Receive Penalty Relief"

IR-2003-46, April 7, 2003, "States Back Offshore Compliance Effort: Key States Extend Benefits for Those Who Apply by April 15"

IR-2003-58, May 1, 2003, "Early Data Show String Response to Offshore Initiative; Applicants Owe Millions, Reveal Scores of Promoters"

IR-2003-73, June 3, 2003, "IRS Announces New Tax Exempt Bond Pilot Program to Mediate and Speed Up Resolution Disputes"

IR-2003-95, July 30, 2003, "Offshore Compliance Program Shows Strong Results"

IR-2004-19, February 10, 2004, "IRS, States Move Forward in Fight Against Abusive Tax Avoidance"

IR-2004-64, May 5, 2004, "IRS Offers Settlement for Son of Boss Tax Shelter"

IR-2004-87, July 1, 2004, "Strong Response to 'Son of Boss' Settlement Initiative"

Notice 2000-44, September 5, 2000, "Tax Avoidance Using Artificially High Basis"

Notice 2001-60, October 1, 2001, "Voluntary Closing Agreement Program for Tax-Exempt Bonds"

Notice 2002-34, May 28, 2002, "IRS Announces Voluntary Compliance Program to Promote Disclosure by Political Organizations"

Notice 2007-18, February 26, 2007, "Definition of Party and Allocation of Net Income or Proceeds for Purposes of Section 4965"

**Sections from the Internal Revenue Manual:**

Internal Revenue Service Website, "Internal Revenue Manual: Part 4. Examining Process," Chapter 75. Exempt Organizations Examination Procedures, Section 25. Exempt Organizations Examinations Closing Agreements, as of May 4, 2007

Internal Revenue Service Website, "Internal Revenue Manual: Part 7. Rulings and Agreements," Chapter 2. TE/GE Closing Agreements, as of October 30, 2006

Internal Revenue Service Website, "Internal Revenue Manual: Part 7. Rulings and Agreements," Chapter 2. TE/GE Closing Agreements, Section 3. Tax Exempt Bonds Voluntary Closing Agreement Program, as of January 12, 2007

Internal Revenue Service Website, "Internal Revenue Manual: Part 20. Penalty and Interest," Chapter 1. Penalty Handbook, Section 1. Introduction and Penalty Relief, as of January 10, 2007

Internal Revenue Service Website, "Internal Revenue Manual: Part 20. Penalty and Interest," Chapter 1. Penalty Handbook, Section 8. Employee Plans and Exempt Organizations Penalties, as of January 11, 2007

Internal Revenue Service Website, "Internal Revenue Manual: Part 20. Penalty and Interest," Chapter 1. Penalty Handbook, Section 8. Employee Plans and Exempt Organizations Penalties, Exhibits 20.1.8-2 & 20.1.8-3, as of January 11, 2007

**Revenue Procedures:**

Rev. Proc. 97-15, Tax-Exempt Bonds; Private Activity Bonds

Rev. Proc. 2003-11, Offshore Voluntary Compliance Initiative

Rev. Proc. 2006-27, 26 CFR 601.202: Closing Agreements, Part III. Administrative, Procedural and Miscellaneous

**Government Reports:**

Advisory Committee on Tax Exempt and Government Entities (ACT) Report of Recommendations, Public Meeting Washington DC, June 9, 2004, Internal Revenue Service, Publication 4344 (5-204), Catalog Number 38578D

Proposal for an Exempt Organizations Voluntary Compliance Program

“Remedial Actions Applicable to Tax-Exempt Bonds Issued by State and Local Governments,” Internal Revenue Service, Department of the Treasury, [4830-01-p], 26 CFR Part 1, TD 9150, RIN 1545-BC40, August 13, 2004

Avaneesh Bhagat, Program Coordinator, “Employee Plans’ Compliance Resolution System (EPCRS),” Internal Revenue Service, TEGE Division, Revenue Procedure 2006-27, September 1, 2006

Strategic Goal 1: “Improve Customer Service,” IRS Oversight Board Annual Report 2006, January 2007

Topic 17: “Most Serious Problem: Inadequate Taxpayer Service to Exempt Organizations, Resulting in Unnecessary Penalties,” National Taxpayer Advocate 2005 Annual Report to Congress, Volume 1

Topic 19: “Taxpayer “No Response” Rates” National Taxpayer Advocate 2006 Annual Report to Congress, Volume 1

Key Legislative Recommendation 1: “Revising Congressional Budget Procedures to Improve IRS Funding Decisions,” National Taxpayer Advocate 2006 Annual Report to Congress, Volume 1

Key Legislative Recommendation 5: “Increase the Exempt Organization Information Return Filing Threshold,” National Taxpayer Advocate 2006 Annual Report to Congress, Volume 1

TIGTA, Trends in Exempt Organizations Function Enforcement Activities for Fiscal Years 2001-2005, Reference Number: 2006-10-157, September 22, 2006,

Michael R. Phillips, Deputy Inspector General for Audit, “Final Audit Report-The Indian tribal Governments Office’s Administration of the Tip Compliance Program for its Customer Base Increased Voluntary Compliance (Audit #200610027),” Treasury Reports, 2006 Tax Notes Today 180-63, September 8, 2006, Reference Number: 2006-10-131, Tax Analysts, view date: September 18, 2006

“Tax Policy and Administration: Improvements for More Effective Tax-Exempt Bond Oversight,” Report to the Chairman, Subcommittee on Human Resources and Intergovernmental Relations, Committee on Government Operations, House of Representatives, United States General Accounting Office, GAO/GGD-93-104, May 1993

**Testimony and Written Statements:**

“Written Testimony of Commissioner of Internal Revenue Mark Everson before State Committee on Homeland Security and Governmental Affairs’ Permanent Subcommittee on Investigations Hearing on Offshore Abuses: The Enablers, The Tools and Offshore Secrecy,” 2006 Tax Notes Today 148-37 Section 6700-Promoting Abusive Tax Shelters, Tax Analysts, August 1, 2006

“Written Statement of Nina E. Olson National Taxpayer Advocate Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, United States Senate Hearing on The Tax Gap,” Doc 2006-20144, Tax Analysts, September 26, 2006



**APPENDIX 3: Comparison of TE-GE Voluntary Compliance Programs**

	<b>Central Office</b>	<b>Confidential Contacts</b>	<b>Revenue Procedure or Other Guidance</b>	<b>User Fees</b>	<b>Standard for Relief</b>	<b>Publicize Program</b>	<b>Closing Agreements</b>
<b>EP EPCRS</b>	Yes (VCP applications submitted centrally, but coordinators located in Seattle, Dallas, Chicago, and Brooklyn)	Yes	Rev. Proc. 2006-27	Sliding scale, based on number of plan participants	Not available to correct "operational failures that are egregious," "diversion or misuse of plan assets," or "abusive tax avoidance transactions"	Yes, to practitioners and employers	Yes, with correction of any plan defects
<b>TEB VCAP</b>	Yes, TEB Compliance and Program Management	Yes, but examination may begin if name of bond issue not disclosed	Notice 2001-60; IRM 7.2.3; Rev. Proc. 97-15	No (but payment of a "closing agreement amount" is typically required)	Violations not under examination, under challenge in court, and "not due to willful neglect"	Yes, to practitioners and tax-exempt bond community	Yes, but may be reopened "in the event of fraud, malfeasance, or misrepresentation of a material fact"
<b>ITG TEFAC</b>	Yes (submitted online)	No	Form 13797 (11-2006)	No	Must be current in all filings due	Yes, through IRS web site and ACT communications	Not applicable, filing delinquencies addressed through existing mechanisms
<b>EO Alien Withholding</b>	Yes (Manager EPP, Dallas)	No	Rev. Proc. 2001-20	No	Reasonable cause	Yes, to practitioners at "key district" liaison meetings	"Acknowledgment letter" indicating "substantial compliance" – "will not be used as the basis to initiate an examination"
<b>EO Net Revenue Stream</b>	Yes (EO Technical)	No	Announcement 92-70	No	No, but transaction must be rescinded	Yes	Available (but none requested)
<b>EO 527 Nonfiling</b>	Yes	No	Notice 2002-34	No	No tax, penalty, or interest "solely because" the organization failed to file	Yes, to practitioners and through press release	No
<b>Proposed: Transitional EO (PPA nonfiling)</b>	Yes	No	Yes	Fees for Organizations with > \$1M	Not available if under examination or in court	Yes, as widely as possible	Yes, simplified
<b>Proposed: Ongoing EO (nonfiling; withholding)</b>	Yes	Yes	Yes	Fees for Organizations with > \$1M	Not available unless reasonable cause shown, or if under examination, or in court	Yes, as widely as possible	Yes



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

**AFTER THE BONDS ARE ISSUED:  
THEN WHAT?**

**Joan M. DiMarco  
Robert E. Donovan  
Maxwell D. Solet**

**Project Leaders**

**June 13, 2007**



This ACT project resulted from the recognition that many governmental issuers of tax-exempt bonds and private, nongovernmental conduit borrowers were not adequately prepared to monitor ongoing compliance with federal law with respect to such bonds. There was particular concern for newly-elected or appointed officials who might have little prior experience with tax-exempt debt.

This project complements the 2005 ACT report, which included recommendations as to record retention. That report has prompted a growing discussion about appropriate record retention procedures in the tax-exempt bond area.

After consultation with senior personnel in the Tax Exempt and Government Entities Division, the ACT decided that it would prepare a paper on post-issuance compliance in a format appropriate for inclusion in the "Information for the Tax Exempt Bond Community" section of the IRS website. The goal was to provide a product at a level of generality suitable for elected or appointed officials, identifying areas requiring compliance procedures without attempting to ask and answer all possible questions. That product is attached as an exhibit hereto.

Initial discussions were held in late Fall 2006, with representatives of the Tax-Exempt Finance Committee of the Tax Section of the American Bar Association (ABA), the Debt Finance Committee of the Government Finance Officers Association (GFOA), and the National Association of Bond Lawyers (NABL) to confirm that the proposed project seemed a useful one. The ACT learned that NABL and GFOA were engaged in preparation of a detailed post-issuance compliance "checklist," aimed principally at bond counsel, and discussed with those groups the development of a project which, because of its different target audience and greater level of generality, would avoid being duplicative of their efforts. ACT members spoke again with these three groups in early Spring 2007, to share a draft of the paper presented here. The final version reflects their helpful comments.

This report is being delivered at a time of increased focus in IRS tax-exempt bond audits on post-issuance compliance rather than exclusively on matters which support the initial opinion of bond counsel, delivered at closing, that interest on the bonds is excludable from the gross income of the bondholders. These audits appear to support the perception that there is a wide range of practice among issuers and conduit borrowers in terms of their use of systematic procedures for monitoring post-issuance tax compliance.

The ACT believes that voluntary implementation of better procedures for monitoring compliance will substantially improve overall compliance, well beyond what can be achieved through the audit process. At the same time, it should greatly improve the efficiency of tax exempt bond audits. The ACT urges the IRS to encourage improved compliance procedures on a forward-looking basis without drawing negative inferences with respect to prior procedures in the inherently backward-looking context of the audit process. Issuers, and conduit borrowers, vary substantially with respect to their size, their resources, and the number and complexity of their bond transactions. There can

After the Bonds Are Issued: Then What?

be no one-size-fits-all set of procedures. However, each issuer or borrower should identify and establish appropriate procedures to ensure that its bonds remain in compliance with this complex body of federal tax law.

## Exhibit

### **AFTER THE BONDS ARE ISSUED: THEN WHAT?**

The closing date of a tax-exempt bond issue usually is the culmination of weeks or months of negotiation and planning. That process includes extensive fact-gathering and analysis by bond counsel to ensure that the bonds will be in compliance with federal tax law requirements. At closing, bond counsel delivers an opinion that interest on the bonds is properly excluded from the gross income of the bondholders. That opinion is based upon a reasonable expectation that tax law requirements will be complied with throughout the time the bonds remain outstanding. Frequently bond documents include covenants by issuers and conduit borrowers as to post-issuance tax law compliance.

This section is intended to assist treasurers, comptrollers, chief financial officers, and other responsible officials of state or local government issuers of tax-exempt bonds, or of private, nongovernmental conduit borrowers which are allowed to borrow at tax-exempt rates from such governmental issuers, in developing policies, procedures and systems which will ensure that the bonds remain tax-exempt.

Because most tax-exempt bonds will remain outstanding for many years, it is important to have procedures which can be understood and implemented over time even as the responsible officials may change. The particular procedures which are appropriate may vary substantially, depending upon the size and complexity of the issuer/borrower, the complexity of the financing, the number of bond issues to be monitored, and the type of bond issue involved, e.g., governmental general obligations, qualified 501(c)(3) bonds, multifamily housing bonds. Most important is to assign responsibility for post-issuance tax law compliance and to be sure that sufficient information is routinely identified and maintained to allow those who later inherit that responsibility to successfully continue the job. It is appropriate to ask bond counsel at the time of closing to assist in the development of a procedural framework for post-issuance tax compliance.

Whenever possible, monitoring of tax law compliance should be integrated with existing accounting systems so that those who directly manage bond-financed assets will be prompted to identify relevant facts at the time any changes are contemplated and to communicate such plans to the appropriate finance officials. For example, bond-financed property could be specially coded on an existing plant ledger in order to require advance review of contemplated sales, leases, or other contractual arrangements involving bond-financed property.

Because of the long term of many tax-exempt bonds, and the need to verify tax-law compliance throughout the term, special care should be given to record retention policies. Record retention requirements may differ from and be more stringent than those required under state law or other governing rules. See [Tax Exempt Bond FAQs regarding Record Retention Requirements](#) [link] and the discussion of record retention in the [2005 Report of the Advisory Committee on Tax Exempt and Government Entities](#)

[link]. In Notice 2006-63, the IRS solicited comments as to appropriate record retention standards, including recordkeeping limitation programs, and is currently considering industry comments.

The goal of the types of procedures described here is to identify on a timely basis the facts relevant to the continued tax-exemption of outstanding bonds. The analysis of those facts and the crafting of solutions to potential problems may require on-going consultation with bond counsel. Issuers and borrowers should recognize that such consultation may go beyond the scope of bond counsel's initial engagement.

Post-bond issuance tax compliance may include the following:

- Procedure
  - Identify who will be responsible for post-issuance tax compliance and steps to be taken to transfer that responsibility and accumulated information in the future.
  - Where different persons are responsible for different aspects, for example investment of bond proceeds and expenditure of bond proceeds on projects, coordinate record-keeping and review.
  - Determine frequency for review of various items and plan of implementation.
- Issuance
  - Obtain and store “closing bible” of crucial documents prepared by bond counsel.
  - Confirm filing of Form 8038, Form 8038-G or Form 8038-GC with IRS, usually overseen by bond counsel at or soon after closing.
  - Establish plan for keeping relevant books and records as to investment and expenditure of bond proceeds.
- Arbitrage
  - Choose accounting method with respect to bond proceeds and interest earnings, investment, and expenditures.
  - Obtain computation of “yield” of bonds and establish procedure to track investment returns.
  - Establish procedure for allocation of bond proceeds and interest earnings to expenditures, including reimbursement of pre-issuance expenditures.

- Monitor compliance with “temporary period” expectations for expenditure of bond proceeds, typically three years for new money bonds, and provide for yield restriction of investment or “yield reduction payments” if expectations are not satisfied.
- Establish procedures to ensure investments acquired with bond proceeds are purchased at fair market value. These can include use of bidding procedures under regulatory safe harbor.
- Avoid formal or informal creation of funds reasonably expected to be used to pay debt service on bonds without determining in advance whether such funds must be invested at restricted yield.
- Consult with bond counsel before engaging in post-issuance credit enhancement transactions (e.g., bond insurance, letter of credit) or hedging transactions (e.g., interest rate swap, cap).
- Identify situations in which compliance with applicable yield restrictions depends upon later investments, e.g., purchase of 0% SLGS from U.S. Treasury, and monitor implementation.
- Monitor compliance with 6-month, 18-month, or 2-year spending exceptions to rebate requirement.
- Arrange for timely computation of rebate liability and, if rebate is payable, for timely filing of Form 8038-T and payment of rebate. Rebate is ordinarily due at 5-year intervals.
- Arrange for timely computation and payment of “yield reduction payments,” if applicable.
- Issuers/borrowers frequently engage outside arbitrage/rebate consultants to do such computations.
- Private Activity
  - Establish procedure for mapping which outstanding bond issues financed which facilities and in what amounts. Note that a single facility may be financed by multiple bond issues (as well as by other funds), a single bond issue may finance multiple facilities, and a single bond issue may be partially or fully refunded by multiple subsequent bond issues.
  - Establish procedure for allocation of bond proceeds to expenditures, including reimbursement of pre-issuance expenditures. These procedures must be consistent with those used for arbitrage purposes.

- Establish procedure for allocation of bond proceeds and funds from other sources within a bond-financed project to ensure that bond proceeds are used for qualifying costs.
- Monitor expenditure of bond proceeds for qualifying costs.
  - Governmental bonds may be used for a broad range of capital projects and for working capital, subject to arbitrage constraints.
  - Charitable 501(c)(3) organizations can borrow from governmental issuers of bonds for a similarly broad range of uses. However, borrowers must ensure that 501(c)(3) status is maintained and that bond proceeds are not used in connection with an “unrelated trade or business”.
  - Exempt facility and other special use bonds have particular rules as to what are qualifying costs. In some cases, such as housing bonds, there are continuing reporting requirements to the IRS.
- Monitor private use of bond-financed facilities (in the case of qualified 501(c)(3) bonds, monitor non-501(c)(3) private use) to ensure compliance with applicable percentage limitations.
  - Establish procedure for review of amount of existing private use on periodic basis.
  - Establish procedure for identifying in advance any new sale, lease or license, management contract, sponsored research arrangement, or other arrangement involving private use of bond-financed facilities.
  - Promptly consult with bond counsel as to any possible private use of bond-financed facilities. “Remedial action” for such “change of use” may require redemption or defeasance of bonds or expenditures for other qualified purposes within specified time periods.
- Reissuance
  - Identify any post-issuance change to terms of bonds which could be treated as a current refunding of “old” bonds by “new” bonds, often referred to as a “reissuance”.
  - Confirm whether any “remedial action” in connection with a “change of use” must be treated as a “reissuance”.

Post-issuance tax compliance is an integral part of an issuer or borrower's debt management process. In some organizations, compliance may be adequately supported by ad hoc procedures or by the efforts of a single individual. However, consideration should be given to whether ongoing timely, reliable institutional compliance should be supported by practices integrated within the core policies and procedures of the institution. Such practices may assist newly elected or appointed officials in quickly identifying and understanding existing policies and remedies and who is responsible for their implementation in order to avoid a disruption of necessary activities.

Post-issuance tax compliance begins with the debt issuance process itself and provides for a continuing focus on investments of bond proceeds and use of bond-financed property. It will require identifying existing policies, the responsible people, the applicable procedures, and the affected population. The facts will differ for every issuer or borrower. The questions may differ as well. The need for effective policies, procedures, and systems to ensure compliance will not.



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

**IMPROVING COMPLIANCE FOR ADOPTERS  
OF PRE-APPROVED PLANS**

**Charles M. Lax, Project Leader  
Susan Diehl  
Dodi Walker Gross  
Charles F. Plenge  
Daniel J. Schwartz  
Michael S. Sirkin**

**June 13, 2007**

This page left intentionally blank

**TABLE OF CONTENTS**

**I. EXECUTIVE SUMMARY .....5**

**II. INTRODUCTION.....7**

    A. Reason for Report.....7

    B. ACT’s Objective and Guiding Principles.....9

    C. Constituencies under the PAP Program.....10

**III. LEGAL BACKGROUND .....13**

    A. Legal Requirements for all Qualified Plans .....13

    B. Document Approval Process .....13

        1. General Classification of Plans .....13

        2. Approval Process for PAPs and IDPs.....15

    C. Qualified Plan Failures..... 16

        1. Types of Plan Failures .....16

        2. Employee Plans Compliance Resolution System (EPCRS)..... 17

**IV. PRE-APPROVED PLAN BACKGROUND .....19**

    A. History of Pre-Approved Plan Program .....19

    B. Current Requirements for Pre-Approved Plans .....26

        1. M&P Plans .....27

        2. Volume Submitter Plans .....31

**V. DATA GATHERING PROCESS .....32**

    A. Sponsoring Organizations .....32

    B. Adopting Employers and Practitioners .....33

    C. The IRS .....34

**VI. FINDINGS AND CONCLUSIONS .....35**

    A. General Observations and Recommendations of the Constituencies .....35

        1. From Senior IRS Personnel Interviews .....35

        2. From Sponsoring Organization Representatives .....36

        3. Summary of Survey Results .....37

            a. Most Common Failures .....38

            b. Frequent Failures in PAPs .....39

            c. Recommendations .....39

    B. Conclusions .....41

**VII. RECOMMENDATIONS .....41**

    A. Increased Responsibilities for Sponsoring Organizations..... 41

        1. Acknowledgement and Information Form .....41

        2. Simplified M&P Plans .....42

        3. Document Retention Policy .....43

- B. IRS Education and Outreach for Adopting Employers .....43
  - 1. Use of IRS Newsletters .....43
  - 2. Special IRS Publication for Adopting Employers..... 44
  - 3. Self-Audit Checklist .....44
  - 4. Specialized Web Site .....44
- C. Other Recommendations .....45
  - 1. IRS Audit Functions .....45
  - 2. Use of M&P Plans by Multiple Employer Groups .....45
  - 3. Publication of Additional Guidance .....45

EXHIBIT A – Summary of BenefitsLink Survey (33 Responses)

EXHIBIT B – Summary of BenefitsLink Survey (110 Responses)

EXHIBIT C – Pre-Approved Plan Acknowledgement and Information Form

I.

**EXECUTIVE SUMMARY**

**Reason for Report**

During the past 20 years, the use of Master and Prototype plans (“M&P plans”) and Volume Submitter plans (“VS plans”) and together with M&P plans referred to hereinafter as “PAPs”) has increased dramatically. Currently, the Internal Revenue Service (“IRS”) estimates that at least 94% of all qualified retirement plans are PAPs. Current and past ACT members have identified compliance issues with regard to many of these plans. While in many instances non-compliance is unintentional, the ACT believes it results from the nature and structure of the PAP program. This project arises from a need to provide assistance to employers who have adopted M&P plans and VS plans in complying with the requirements applicable to tax-qualified retirement plans.

**Objective**

The ACT’s objective for this project was to develop a series of recommendations that will enhance document and operational compliance. In accomplishing this objective, the ACT was guided by these principles:

- The current character of the PAP program should remain intact.
- The ACT would engage each of the constituencies (the IRS, employers adopting PAPs (“Adopting Employers”), and M&P plan sponsors and VS Practitioners (collectively referred to as “Sponsoring Organizations”) involved with the PAP program and solicit their views.
- The recommendations should be realistic and workable and not impose a significant burden on any constituency.
- The emphasis should be on recommendations that are particularly suited for enhancing compliance by small employers.

**Recommendations**

**Increased Responsibilities for Sponsoring Organization**

1. Each M&P plan Sponsoring Organization should include a form which becomes part of the Adoption Agreement (i) advising Adopting Employers of the responsibilities of adoption of a PAP and (ii) including a list of the parties

responsible for performing various administrative functions on behalf of the plan.

2. Each M&P plan Sponsoring Organization should be required to offer a simplified version of their plan with few or no options.
3. Each M&P plan Sponsoring Organization should be required to retain and make available copies of their own plan documents, amendments and opinion letters for an indefinite period of time.

### **IRS Education and Outreach for Adopting Employers**

1. Subscriptions to the IRS' quarterly publication entitled "*Retirement News for Employers*" should be increased by requiring Sponsoring Organizations to enroll new Adopting Employers whenever possible.
2. The IRS should develop a new publication for Adopting Employers which assists them in implementing a PAP, completing an Adoption Agreement, obtaining a determination letter and updating and amending plans for new legislation and guidance.
3. The IRS should develop a new, "self-audit" checklist for Adopting Employers similar to the checklists developed for 401(k) plans, SEPs and 403(b) plans.
4. The IRS should develop a new web site for small Adopting Employers similar to the web site it has created for small tax-exempt organizations.

### **IRS Audit and Guidance Functions**

1. The IRS should implement a permanent audit program for Sponsoring Organizations to determine levels of compliance with IRS requirements for organizations maintaining a PAP.
2. The IRS should modify and expand Rev. Proc. 2005-16 to permit non-commonly controlled, multiple employer groups to adopt M&P plans.
3. The IRS should publish additional guidance to better clarify responsibilities of Sponsoring Organizations where: (a) Adopting Employers do not respond to amendments or other information requests of the Sponsoring Organization, or (b) where the Sponsoring Organization has a reasonable belief that a document or operational failure occurred.

## II.

### **INTRODUCTION**

#### **A. Reason for Report**

The retirement policy of the United States is designed to extend tax-qualified retirement plans to a wide array of employers, so as to make them available to as many employees as possible. Unfortunately, there are many employers who are neither equipped to comply, nor willing to pay for compliance with the complex requirements of the Internal Revenue Code of 1986, as amended (“Code”). In addition there are many employers who do not recognize the need for continuing administration of these plans. The result has created an environment of non-compliance. The ACT believes that in most instances the lack of compliance is not intentional, but is a result of the complex legal requirements for maintaining a tax-qualified retirement plan and an assumption that other persons are responsible for compliance.

This project arises from a need to provide assistance to employers who have adopted M&P plans and VS plans in complying with the requirements applicable to tax-qualified retirement plans. The ACT has focused on these plans due to their dramatic proliferation during the past 20 years. Based on the IRS’ estimates, at least 94%<sup>1</sup> of all tax qualified retirement plans are PAPs. Non-compliance can take the form of plan document failures or operational failures. While there is no conclusive evidence that non-compliance is more likely to occur in PAPs, there is anecdotal evidence that some failures are more likely to occur in PAPs.

The need for this project has also been recognized by the current leadership of TE/GE. In a speech delivered at the Benefits Conference of the South on March 20, 2006, TE/GE Commissioner, Steven T. Miller, stated:

...

In light of their increasingly central nature and importance in retirement, should we begin to focus more on ensuring that defined

---

<sup>1</sup> There are no definitive statistics for this percentage. This estimate by the EP Division results from an assumed universe of approximately one million qualified retirement plans and approximately 60,000 individually designed plans that filed for a determination letter during the GUST restatement period. It is also noted that this percentage may even be larger than 94% today, based upon the number of individually designed plans that were submitted for determination letters during the recently completed Cycle A. The above 94% is based on the number of plans; however, the ACT has no statistics on what percentage of the universe of plan assets and employees covered by retirement plans are represented by the PAPs.

contribution plans cover all who they must cover and that the rights and assets of participants remain protected?

. . .

Are participants including retirees getting the service they should from plan administrators? Also, as we see more and more adoption of mass marketed plans, how do we best police follow up compliance in such plans?

. . .

The EPCU is staffed with Senior EP Agents, Analysts, Statisticians and Economists. Since June 2005, when the EPCU stood up, it has performed more than 1,500 compliance checks. In the long term, the unit is going to conduct correspondence examinations and support our efforts to attack abusive tax schemes.

. . .

I have also asked them to work on a compliance project to see how mass marketed plans are doing post-adoption. The EPCU will allow us the flexibility to design and execute compliance projects to accommodate a shift of mission. I promise that things will get even more interesting.

. . .

Additionally, prior ACT Reports have commented on the M&P plan program and made suggestions for improvement. For example, in the June 21, 2002 First ACT Report entitled "Employee Plans Small Business Access and Compliance Project," ACT members recommended that the IRS obtain lists of PAPs for use in a focused audit program, as well as require Sponsoring Organizations to provide Adopting Employers with operational manuals. Furthermore, in the June 9, 2006 Fifth ACT Report entitled "Document Compliance Program for 403(b) Arrangements," ACT members noted "Current members of the ACT continue to express their concerns over many plan document preparation and plan operation/administration failures that appear to accompany the marketing and use of pre-approved plans by some vendors and practitioners in this market."

## **B. ACT's Objective and Guiding Principles**

In approaching this project, the ACT established as its principal objective the development of a series of recommendations that will enhance document and operational compliance among Adopting Employers. To this end, the ACT was guided by these principles:

- The current character of the PAP program should remain intact.
- The ACT would engage each of the constituencies that are involved with the PAP program and solicit their views to assure each constituent that their group has been recognized and considered.
- The non-compliance is not the “fault” of any one of the constituencies, but is inherent in the system.
- The recommendations should address the most common plan failures.
- The recommendations should be realistic and workable, and not add unnecessary burdens on any constituency, thereby increasing the likelihood that each of the affected constituencies would be receptive to their implementation.
- A broad range of recommendations that affects no single constituency disproportionately should be provided.
- The emphasis should be placed on recommendations that are particularly suited for enhancing compliance by the smallest of Adopting Employers; it appearing to the ACT that the maintenance of a qualified plan, albeit a PAP, is most challenging for this type of employer.
- The report and recommendations should not address the determination letter process, the staggered remedial amendment rules, or the proliferation of “interim amendments,” it being the ACT’s opinion that any critical analysis of these matters would not be timely until the first cycle of plan restatements and amendments has been completed.<sup>2</sup>

---

<sup>2</sup> The first cycle of restatements and amendments for PAPs under the new staggered remedial amendment scheme is scheduled to end on January 31, 2011.

## **C. Constituencies under the PAP Program**

### **1. Sponsoring Organizations**

Generally the Sponsoring Organization is the entity which “sponsors” the plan by writing and submitting the plan to the IRS and assures the “qualified” status of the plan for the Adopting Employer. This term includes the following entities: M&P Sponsoring Organizations, M&P Mass Submitters, National Sponsoring Organizations, VS Practitioners, and VS Mass Submitters. Each of these entities is described below.

#### **(a) M&P Sponsoring Organizations**

Commencing with the GUST<sup>3</sup> plan submissions, the IRS no longer limited the types of organizations that were eligible to sponsor M&P Plans. Prior to 2000, Sponsoring Organizations were limited to:

- Banks
- Credit unions
- Insurance companies
- Regulated investment companies (mutual funds)
- Investment advisors that have an advisory contract with one or more regulated investment companies
- Principal underwriters that have a principal underwriting contract with one or more regulated investment companies
- IRS-approved non-bank trustees
- Trade or professional organizations

Effective with the GUST plan restatements, a Sponsoring Organization may include any person that (1) has an established place of business in the United States which is accessible during every business day and (2) represents to the IRS that it has at least 30 employer-clients each of which is reasonably expected to timely adopt the Sponsoring Organization’s basic plan document. A Sponsoring Organization may request opinion letters for any number of basic plan documents and adoption agreements, provided the 30-employer requirement is met with respect to at least one

---

<sup>3</sup> The GUST amendments were a series of required amendments to all qualified retirement plans. “GUST” refers to the first letters of four of the six laws from which the required amendments are derived: (1) the Uruguay Round Agreements Act or the Uruguay Round of the General Agreement on Taxes and Tariffs (“GATT”); (2) the Uniformed Services Employment and Reemployment Rights Act of 1994 (“USERRA”); (3) the Small Business Job Protection Act of 1996 (“SBJPA”); (4) the Taxpayer Relief Act of 1997 (“TRA ‘97”); (5) the Internal Revenue Service Restructuring and Reform Act of 1998; and (6) the Community Renewal Relief Act of 2000.

basic plan document. Notwithstanding the above, any person that has an established place of business in the United States which is accessible during every business day may sponsor a plan as a word-for-word identical adopter or minor modifier adopter of a plan of an M&P Mass Submitter, regardless of the number of employers that are expected to adopt the plan.

By submitting an application for an opinion letter for an M&P plan under Rev. Proc. 2005-16 (or by having an application filed on its behalf by an M&P Mass Submitter as required for a minor modifier), a person represents to the IRS that it is a Sponsoring Organization, as defined above, and agrees to comply with any requirements imposed on Sponsoring Organizations by such Revenue Procedure.

(b) M&P Mass Submitter

An “M&P Mass Submitter” is any person that (1) has an established place of business in the United States which is accessible during every business day and (2) submits opinion letter applications on behalf of at least 30 unaffiliated Sponsoring Organizations, each of which is sponsoring, on a word-for-word identical basis, the same basic plan document. An M&P Mass Submitter will be treated as an M&P Mass Submitter with respect to all its M&P plans, provided the 30 unaffiliated Sponsoring Organizations requirement is met with respect to at least one basic plan document. There is an exception for any M&P Mass Submitter that received a favorable TRA '86 opinion letter for a plan as an M&P Mass Submitter under the previous Rev. Proc. 89-9. Such M&P Mass Submitter will continue to be treated as an M&P Mass Submitter with respect to all its M&P plans, if it submitted applications on behalf of at least 10 Sponsoring Organizations, each of which is sponsoring, on a word-for-word identical basis, the same basic plan document.

(c) National Sponsoring Organization

A “National Sponsoring Organization” is a Sponsoring Organization that has either (a) 30 or more Adopting Employers in each of 30 or more states (treating, for this purpose, the District of Columbia as a state) or (b) 3000 or more Adopting Employers.

(d) Volume Submitter Practitioner

A “VS Practitioner” is any person that (1) has an established place of business in the United States, which is accessible during every business day and (2)

represents to the Service that it has at least 30 employer-clients, each of which is reasonably expected to timely adopt a plan that is substantially similar to the VS Practitioner's specimen plan. There is an exception in the case of money purchase pension plans, where the required number of employer-clients reasonably expected to timely adopt a substantially similar money purchase pension specimen plan is generally reduced to 10. A VS Practitioner may submit any number of specimen plans for advisory letters, provided the 30 employer requirement (or 10, if applicable) is separately satisfied with respect to each specimen plan. Notwithstanding the above, any person that has an established place of business in the United States which is accessible during every business day may sponsor a specimen plan as a word-for-word identical adopter of a specimen plan of a VS Mass Submitter, regardless of the number of employers that are expected to adopt the plan.

(e) VS Mass Submitter

A "VS Mass Submitter" is any person that (i) has an established place of business in the United States, which is accessible during every business day, and (ii) submits advisory letter applications on behalf of at least 30 unaffiliated practitioners each of which is sponsoring, on a word-for-word identical basis, the same specimen plan. A VS Mass Submitter may submit an advisory letter application on its own behalf as one of the 30 unaffiliated practitioners.

**2. Adopting Employer**

The Adopting Employer or "plan sponsor" is generally the corporation, unincorporated business or employee association adopting the plan.

**3. Internal Revenue Service**

The IRS is the agency that sets the requirements with regard to the M&P and VS programs, approves plan documents, and determines whether a Sponsoring Organization has satisfied its duties and obligations under the most current Revenue Procedure regarding the submission of M&P plan or Volume Submitter plan documents.

### III.

#### **LEGAL BACKGROUND**

##### **A. Legal Requirements for all Qualified Plans**

In order for employer-sponsored retirement plans, such as 401(k) plans, profit-sharing plans and defined benefit pension plans (including so-called cash balance plans), to enjoy the tax benefits offered to those employers and to employees covered by those plans,<sup>4</sup> the Code imposes a complex set of rules, which are implemented through a series of regulations, rulings and other IRS guidance. These Code requirements include rules regarding (i) eligibility to participate, (ii) vesting of benefits, (iii) accrual of benefits or allocation of employer and employee contributions, (iv) prohibitions on discrimination in favor of highly-compensated employees, (v) distribution of benefits, (vi) use of plan assets for the exclusive benefit of plan participants, and (vii) obligations and timing of required amendments to the plans.

This series of lengthy and complex requirements imposed on qualified retirement plans, including the large number of permitted alternatives, requires knowledgeable assistance in the design, implementation and ongoing administration of those plans.

##### **B. Document Approval Process**

###### **1. General Classification of Plans**

From a document standpoint, generally, there are two classifications into which all qualified retirement plans can be divided: PAPs and individually designed plans (“IDPs”). PAPs are plans which are submitted to the IRS by the Sponsoring Organizations and receive an opinion letter or advisory letter pre-approving the plan's language.<sup>5</sup> An IDP is a plan which is specifically designed for one employer or a group of employers and then submitted to the IRS for a determination letter. The purpose of the document approval process is to provide employers and plans assurance that their plan document complies with the requirements of the Code and other IRS guidance.

M&P plans can be further divided into two sub-classes: standardized and nonstandardized. A standardized plan is an M&P plan which meets specific criteria outlined by the IRS. This type of plan restricts the choices that are available to Adopting

---

<sup>4</sup> The benefits include a permitted deduction to the employer upon the contribution, while deferring the income inclusion to the employees until distribution.

<sup>5</sup> As discussed below, some Adopting Employers also seek their own determination letter with respect to special provisions of the plan and non-discrimination issues.

Employers. For this reason, once a standardized M&P plan receives an opinion letter from the IRS, there is no need for an individual employer to request a determination letter. The IRS' opinion letter is all that is needed to provide that Adopting Employer assurance that the form of their plan is acceptable.

A standardized M&P plan must meet the following requirements:<sup>6</sup>

- The plan's eligibility and participation requirements must generally be extended to all employees except those who: (i) do not meet the age and service requirements, (ii) are nonresident aliens with no US source income, or (iii) are members of a collective bargaining unit.
- The plan's eligibility requirements may not be more favorable for highly compensated employees than other employees.
- Total compensation (e.g., exclusion of bonuses and/or overtime is not permitted) must be used in allocating contributions in a defined contribution plan or calculating benefits in a defined benefit plan. However, integration of the plan with Social Security is permitted.
- Only participants who terminate employment during the year and have less than 500 hours of service during the year may be excluded from an allocation or an accrual for such plan year.
- Unless the plan is a target benefit plan or a 401k/m plan, contributions or accruals must meet the design-based safe harbors of Code Section 401(a)(4).
- Crediting past service for participants must meet the safe harbor contained in Reg. Section 1.401(a)(4)-5(a)(3).

A non-standardized plan is an M&P plan which does not meet the standardized plan requirements. As such, a non-standardized plan may have many more options and choices available to the Adopting Employer. However, because of this, not only does the plan receive an M&P opinion letter from the IRS, but the Adopting Employer in many instances also must submit the plan along with the choices selected in the Adoption Agreement to the IRS for an individual determination letter.<sup>7</sup>

---

<sup>6</sup> Rev. Proc. 2005-16, 2005-10 I.R.B. 674 at §4.10

<sup>7</sup> Under certain circumstances, an adopter of a non-standardized plan may get reliance from the Sponsoring Organization's opinion letter if the requirements of §19.02(2), (3), and (4) of Rev. Proc. 2005-16 are met.

A VS plan is a specimen or sample plan sponsored by a VS Practitioner, which is submitted to the IRS for its pre-approval.<sup>8</sup> If approved, the IRS will issue to the Sponsoring Organization an advisory letter. VS plans have greater flexibility and generally more options than are available in M&P plans. For example, Adopting Employers may vary their document and include provisions that are not part of the VS Practitioner's specimen plan and still be considered as an adopter of a VS plan. This is unlike the requirement for M&P plan adopters that the plan must be adopted word-for-word without any changes to the language in the plan. For an Adopting Employer to obtain reliance, the employer may be required to submit the plan to the IRS for an individual determination letter.<sup>9</sup>

## 2. Approval Process for PAPs and IDPs

The approval process for a PAP is based on a 6-year approval cycle.<sup>10</sup> Sponsoring Organizations were required to submit PAPs to the IRS for EGTRRA and other requirements (outlined in the 2004 Cumulative List)<sup>11</sup> by January 31, 2006. It is anticipated that those plans will be reviewed and approved by the IRS by January 31, 2008. It is then anticipated that the IRS will allow Adopting Employers to complete the adoption of these amended plans during the period ending January 31, 2010 (although the 6-year approval cycle contains the flexibility to extend that date through January 31, 2011). The next submission deadline for PAPs will be January 31, 2012. For certain intervening legislative changes and other guidance issued by the IRS, interim amendments may be required.

The determination letter process for IDPs is based on a 5-year rolling period.<sup>12</sup> These 5-year cycles are determined by the last digit of the employer's EIN. The cycles are based on the following schedule:

- Year 1 - EINs ending in 1 & 6 (Cycle A)
- Year 2 - EINs ending in 2 & 7 (Cycle B)
- Year 3 - EINs ending in 3 & 8 (Cycle C)
- Year 4 - EINs ending in 4 & 9 (Cycle D)

<sup>8</sup> *Id* at §13.01

<sup>9</sup> Like non-standardized plans, an Adopting Employer need not submit for an individual determination letter if the requirements of §19.02(2), (3), and (4) of Rev. Proc. 2005-16 are met.

<sup>10</sup> Rev. Proc. 2005-66, 2005-37 I.R.B. 509

<sup>11</sup> Notice 2004-84, 2004-52 I.R.B. 1030

<sup>12</sup> Rev. Proc. 2005-66 at §9.01

### Year 5 - EINs ending in 5 & 0 (Cycle E)

The deadline for Cycle A submissions was January 31, 2007. Cycle B plans will be due on January 31, 2008, and so on. There are also special exceptions for certain types of plans, such as multiple employer plans, collectively bargained plans, and plans maintained by controlled groups of businesses. Employers are also permitted to submit “off-cycle;” however, in many instances these plans will only be reviewed after the “on-cycle” plans have been completed.

An employer that maintains an IDP and desires to “convert” to a PAP may be required to execute, along with the Sponsoring Organization, an IRS Form 8905 no later than the end of their submission cycle. This will permit the employer to adopt the PAP indicated on the Form 8905, when the PAP receives its approval, in lieu of adopting and submitting the IDP for a determination letter during its submission cycle.

### **C. Qualified Plan Failures**

#### **1. Types of Plan Failures**

A qualification or plan failure is any failure that adversely affects the tax qualified status of a plan. Plan failures may be divided into four classifications:<sup>13</sup> (i) plan document failures, (ii) operational failures, (iii) demographic failures, and (iv) employer eligibility failures.

Plan document failures include plan provisions (or the absence of plan provisions) that, on their face, violate the requirements of Section 401(a) or Section 403(a) of the Code. For example, the failure of a plan to be amended to reflect a new qualification requirement within the plan's applicable remedial amendment period under Section 401(b) is considered a plan document failure. Additionally, a “non-amender” (an employer that has not adopted amendments required by legislation or IRS guidance by the required date) would also be considered a plan document failure.

An operational failure is a type of plan failure that arises solely from the failure to administer the plan in accordance with plan provisions. For example, allowing an “in-service” distribution to a plan participant in contravention of the plan's provisions is considered to be an operational failure. A plan does not have an operational failure to the extent the plan is permitted to be amended retroactively pursuant to Section 401(b)

---

<sup>13</sup> Rev. Proc. 2006-27, 2006-2 I.R.B. 945, §5.01(2)  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

or another statutory provision to reflect the plan's operations. However, if within the applicable remedial amendment period under Section 401(b), a plan has been properly retroactively amended for statutory or regulatory changes, but during that retroactive period the amended provisions were not followed, then the plan is considered to have an operational failure.

A demographic failure is the type of plan failure which results from violations of Section 401(a)(4), Section 401(a)(26) or Section 410(b), which are not operational failures or employer eligibility failures. For example, a plan's failure to meet the minimum coverage requirements of Section 410(b) is a demographic failure. Generally, the correction of a demographic failure requires a corrective amendment to the plan document expanding eligibility or benefits for plan participants.

The final type of failure is an employer eligibility failure. These failures result when an employer was not eligible to adopt a certain type of plan. For example, state and local governments are ineligible to adopt 401(k) plans.

## **2. Employee Plans Compliance Resolution System (EPCRS)**

EPCRS is a collection of three programs, which allows employers, Sponsoring Organizations, third party administrators, or an entity that provides administrative services for a qualified plan, 403(b), SEP, or SIMPLE to correct plan failures and thereby continue to provide plan participants with retirement benefits on a tax-favored basis. The current requirements of EPCRS are set forth in Rev. Proc. 2006-27. The three programs<sup>14</sup> include:

- Self-Correction Program (SCP) – The plan sponsor discovers the failure(s) and corrects the failure(s) without IRS involvement. Generally, this program is available to correct insignificant operational failures or any other failure discovered and corrected by the end of the second plan year following the year in which the failure occurred. This program is available even for plans with insignificant failures that are under audit by the Employee Plans Division of the IRS.
- Voluntary Correction Program (VCP) – The plan sponsor discovers the failure(s) and corrects the failure(s) with IRS approval. A compliance fee is

---

<sup>14</sup> *Id* at §4.01

due based on the number of participants in the plan. This program is generally available for operational failures, document failures, demographic failures, and employer eligibility failures.

- Audit Closing Agreement Program (Audit CAP) – This program is an option that is available for the purpose of resolving qualification failures identified by the IRS during an audit of the plan. All types of failures are available for this program. Under this program, the plan sponsor is required to pay a negotiated monetary sanction which represents a negotiated percentage of the tax the IRS could collect if it disqualified the plan.

The general principles of EPCRS are as follows:<sup>15</sup>

- Sponsors of qualified retirement plans, 403(b)s, SEPs, and SIMPLEs should be encouraged to establish administrative practices and procedures that ensure that plans are operated properly in accordance with the tax qualification requirements.
- Sponsors and other administrators of qualified retirement plans should maintain plan documents satisfying the tax qualification requirements.
- Sponsors should make voluntary and timely correction of any plan qualification failures, whether involving discrimination in favor of highly compensated employees, plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer. Timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment.
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the IRS, thereby reducing employers' uncertainty regarding their potential tax liability.
- Fees and sanctions should be set at levels which encourage prompt correction.
- Sanctions for failures identified during an audit should be reasonable in light of all circumstances.

---

<sup>15</sup> *Id* at §1.02  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

- The administration of EPCRS should be uniform and consistent.

#### IV.

### **PRE-APPROVED PLAN BACKGROUND**

#### **A. History of Pre-Approved Plan Program**

M&P plans conceptually date back to the early 1960's.<sup>16</sup> Originally, a master or prototype plan was a standardized form of a qualified plan that could only be made available by a trade or professional association, bank, insurance company, or regulated investment company, and was intended to be used by groups of self-employed individuals.<sup>17</sup> Master plans were those standardized form plans that had a related form of trust or custodial agreement, that was administered by a bank or insurance company which acted as a funding medium to provide the benefits on a standardized basis; whereas a prototype plan need not have included a form of trust agreement, was only for use by employers without modification, and was not administered by the Sponsoring Organization.<sup>18</sup> Rulings as to the acceptability of the M&P plans were made by the National Office of the IRS, and a separate determination letter was required as to the qualification of the plan as adopted by a particular employer.<sup>19</sup> Effective August 1, 1964, M&P plans were required to be filed with the District Office for opinion letters as to the acceptability of the form of plan,<sup>20</sup> but effective January 3, 1972, M&P plans seeking opinion letters were again required to be filed with the National Office.<sup>21</sup>

After receiving repeated requests to create procedures for processing M&P plans to be adopted by corporate employers (as opposed to only employers with self-employed individuals), the IRS promulgated procedures for obtaining opinion letters as to the acceptability of M&P plans that did not include self-employed individuals ("Corporate M&P Plans").<sup>22</sup> Under Rev. Proc. 68-45, a variable form plan was introduced which permitted an employer to select options related to basic plan provisions, but was only

<sup>16</sup> Rev. Proc. 63-23, 1963-2 C.B. 757 (describing "the general procedures of the various offices of the Internal Revenue Service for issuing determination letters relating to the initial qualification of pension, annuity, profit-sharing, and bond purchase plans which cover self-employed individuals, under sections 401(a) and 405(a) of the Internal Revenue Code of 1954 . . .").

<sup>17</sup> *Id.* at §2.02

<sup>18</sup> *Id.*

<sup>19</sup> *Id.* at §2.03

<sup>20</sup> Rev. Proc. 64-30 §3.02, 1964-2 C.B. 944

<sup>21</sup> Rev. Proc. 72-7 §2.01, 1972-1 C.B. 715

<sup>22</sup> Rev. Proc. 68-45, 1968-2 C.B. 957

available to Corporate M&P Plans. From that point forward, the IRS issued separate revenue procedures for Corporate M&P Plans and those M&P plans that included self-employed individuals. By 1972, the only distinguishing characteristic between a master plan and a prototype plan was that a master plan specified the funding organization in the sponsor's application, whereas a prototype plan did not, and instead the Adopting Employer's application specified the funding organization.<sup>23</sup>

After the Code was amended by the Employee Retirement Income Security Act of 1974 ("ERISA"), the IRS ceased reviewing requests for the issuance of opinion letters for M&P plans and determination letters for the adoption of such plans by employers until guidelines could be developed in accordance with the new requirements.<sup>24</sup> The guidelines for defined contribution Corporate M&P Plans<sup>25</sup> and M&P plans for self-employed individuals<sup>26</sup> were issued in 1975. They were somewhat limited and prohibited the issuance of opinion and determination letters with respect to certain types of money purchase pension plans or those with certain provisions.<sup>27</sup> The IRS further required for the first time that employers requesting determination letters for M&P plans notify interested parties of the filing.<sup>28</sup> Later that year, the IRS expanded the program by issuing guidelines that allowed for the issuance of an opinion letter or determination letter for Corporate M&P Plans that were either of a defined contribution or defined benefit nature.<sup>29</sup>

Beginning in March of 1976, the IRS developed a procedure for law firms to obtain approval for a defined contribution plan form which the law firm contemplated using in its submission of determination letters for multiple Adopting Employers. These were referred to as "pattern plans."<sup>30</sup> Pattern plans could not include target benefit, stock bonus, bond purchase, or employee stock ownership plans, or plans adopted by partnerships,<sup>31</sup> and a law firm was limited to two district-approved plans for each type of

---

<sup>23</sup> Rev. Proc. 72-8 §3.02, 1972-1 C.B. 716

<sup>24</sup> Rev. Proc. 74-40, 1974-2 C.B. 4941

<sup>25</sup> Rev. Proc. 75-47, 1975-2 C.B. 581

<sup>26</sup> Rev. Proc. 75-51, 1975-2 C.B. 590

<sup>27</sup> *Supra* notes 10-11

<sup>28</sup> *Id.*

<sup>29</sup> Rev. Proc. 75-52, 1975-2 C.B. 592

<sup>30</sup> Rev. Proc. 76-15, 1976-1 C.B. 553

<sup>31</sup> *Id.* at §3.01

defined contribution plan allowed under Rev. Proc. 76-15.<sup>32</sup> Additionally, the IRS required that the law firm requesting a notification letter as to the acceptability of the pattern plan submit the request simultaneously with an Adopting Employer's request for a determination letter.<sup>33</sup>

In 1977, the IRS created "field prototype plans;" a defined contribution or defined benefit plan that did not include self-employed individuals, submitted by a firm<sup>34</sup> that had at least 10 Adopting Employers in each region for which a notification of acceptability was sought.<sup>35</sup> Unlike pattern plans, field prototype plans did not have to be submitted simultaneously with an Adopting Employer's request for a determination letter,<sup>36</sup> and there was not a limit on the number of field prototype plans a firm could have for each type of plan.<sup>37</sup> Types of allowable plans for the field prototype plan program included unit benefit, fixed benefit, flat benefit, profit-sharing, stock bonus, money purchase, bond purchase, and employee stock ownership plans.<sup>38</sup> Requests for notification letters and determination letters for field prototype plans were required to be submitted to District Offices.<sup>39</sup>

Following the issuance of final ERISA regulations, the IRS issued a "simplified procedure for requesting opinion, notification and determination letters" in connection with M&P, pattern, and field prototype plans.<sup>40</sup> While Rev. Proc. 79-28 did nothing more than refer the sponsors of such plans to the previously issued applicable Revenue Procedure, it was the first instance in which all types of PAPs had been addressed collectively in the same Revenue Procedure; a foreshadowing of what was to come. Again, in the spirit of simplification, the IRS issued Rev. Proc. 80-29 to address both corporate M&P plans as well as "H.R.-10" plans, M&P plans that included self-employed individuals.<sup>41</sup> While the two types of M&P plans were addressed in a single Revenue Procedure, there were still distinctions between H.R.-10 M&P plans and Corporate M&P

---

<sup>32</sup> *Id.* at §4.01

<sup>33</sup> *Id.* at §5.01

<sup>34</sup> A firm is an entity "other than a trade or professional association, bank, insurance company, or regulated investment company." *Id.* at §3.01

<sup>35</sup> Rev. Proc. 77-23, 1977-2 C.B. 530

<sup>36</sup> *Id.* at §5.01

<sup>37</sup> *Id.* at §4.01

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> Rev. Proc. 79-28, 1979 C.B. 569

<sup>41</sup> 1980-1 C.B. 681

Plans. One of the distinctions was that an employer who adopted the H.R.-10 M&P plan received automatic reliance on the plan (i.e., assurance that any disqualification of the plan would not be retroactive), whereas an employer who adopted a Corporate M&P Plan had to obtain a favorable determination letter to receive reliance on the M&P plan.<sup>42</sup> Subsequently, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>43</sup> largely eliminated the distinctions between Corporate M&P Plans and H.R.-10 M&P plans.<sup>44</sup> As a result, the IRS issued Rev. Proc. 84-23 and removed the distinction between the two types of M&P plans, referring to them collectively as “M&P plans.”<sup>45</sup> Under Rev. Proc. 84-23, an employer was entitled to rely on a favorable opinion letter issued for a standardized form of M&P plan the employer had adopted, without having to obtain a determination letter.<sup>46</sup> Where an employer adopted an M&P form of plan other than a standardized form, a determination letter was still required, as the IRS needed to address the particular facts and circumstances of the Adopting Employer.<sup>47</sup>

Rev. Proc. 84-23 also marked the introduction of the Mass Submitter Program.<sup>48</sup> Under this program, an entity faced reduced procedural requirements and expeditious processing; if it could establish that at least ten Sponsoring Organizations would sponsor the identical M&P plan. Sponsoring Organizations only included banks, insured credit unions, insurance companies, regulated investment companies, certain investment advisors, and certain principal underwriters.<sup>49</sup> The Mass Submitter Program was intended as an experimental program to reduce the IRS’s paperwork burden in addressing the required plan amendments to comply with TEFRA’s qualification changes.<sup>50</sup>

Following the changes to qualification requirements imposed by the Tax Reform Act of 1986,<sup>51</sup> which had a specific provision requiring the IRS to accept applications for

---

<sup>42</sup> Rev. Proc. 84-23, 1984-1 C.B. 457

<sup>43</sup> Pub. L. 97-248, 1982-2 C.B. 462

<sup>44</sup> Rev. Proc. 84-23 §3.01

<sup>45</sup> *Id.* at §4.01-02

<sup>46</sup> *Id.* at §3.01

<sup>47</sup> *Id.*

<sup>48</sup> *Id.* at §17

<sup>49</sup> *Id.* at §17.01-03

<sup>50</sup> *Id.* at §3.06

<sup>51</sup> Pub. L. No. 99-514, 100 Stat. 2085 (1986)

opinion letters for M&P plans that included cash or deferred arrangements (CODAs),<sup>52</sup> the IRS issued model amendments for Sponsoring Organizations to use to conform their plans to the new law.<sup>53</sup> Rev. Proc. 87-18 set forth the procedure for submitting the amendments to M&P plans and included priority handling for Mass Submitters.<sup>54</sup>

In the late 1980's, the IRS instituted a fee schedule for opinion and determination letters<sup>55</sup> as required by the Revenue Act of 1987.<sup>56</sup> Pursuant to public comment regarding the excessive nature of the user fee program for Mass Submitter plan adoptions and VS plans,<sup>57</sup> the IRS reduced the fees for those two programs.<sup>58</sup> The fee for a word-for-word adoption of a Mass Submitter's plan was reduced from \$100 to \$50, with a \$15,000 cap on the aggregate amount a Mass Submitter paid within a calendar year.<sup>59</sup> Furthermore, under the revised schedule, a VS plan was no longer subject to the fees for individually designed plans, but instead was assessed a fee of \$1,000 for the lead plan and \$100 for each subsequent adoption of the VS plan.<sup>60</sup> In 1989, the Mass Submitter program became a permanent program for expedited review of plans that complied with the procedures set forth in Rev. Proc. 89-9.<sup>61</sup>

Also, in 1989, the IRS created a program for "regional prototype plans," which lessened the requirements otherwise applicable to uniform plans and allowed practitioners to sponsor M&P plans, in addition to institutional sponsors.<sup>62</sup> Regional prototype plans were not required to use the top-heavy vesting requirements contained in Section 416 of the Code in all cases, and adopters of regional prototype plans were

<sup>52</sup> *Id.* at §1142. Previously, the IRS would not issue opinion letters with respect to plans containing CODAs as described in Section 401(k) of the Code. See Rev. Proc. 84-23 §8.033, 1984-1 C.B. 457.

<sup>53</sup> Notice 87-33, 1987-1 C.B. 380 (containing model amendments for M&P plans to comply with the qualification requirements under the Tax Reform Act of 1986); Notice 87-34, 1987-1 C.B. 390 (containing a model amendment for sponsors of M&P plans to include a CODA).

<sup>54</sup> 1987-1 C.B. 709. Mass Submitters were those entities that had previously applied for and received favorable opinion letters on a profit-sharing plan for ten or more qualified sponsoring organizations. *Id.* at §5.01

<sup>55</sup> Rev. Proc. 88-8, 1998-1 C.B. 628

<sup>56</sup> Pub. L. 100-203 § 10511

<sup>57</sup> Rev. Proc. 89-4 §6.02, 1989-1 C.B. 767 (defining a volume submitter plan as "a pension, profit-sharing or stock bonus plan the form of which meets certain criteria established by an individual key district which is submitted pursuant to procedures established by the key district for filing determination letter applications under the district's volume submitter program"). Rev. Proc. 90-17 §6.02(b), 1990-1 C.B. 479 defines a volume submitter specimen plan as a volume submitter plan "that is submitted to the key district office by a practitioner who certifies that no fewer than 30 employers within any two regions of the Service are expected to adopt a plan that is substantially identical to the specimen plan following the district office's approval of the specimen plan."

<sup>58</sup> *Id.* at §§2.02-03

<sup>59</sup> *Id.* at §2.02

<sup>60</sup> *Id.* at §2.03

<sup>61</sup> 1989-1 C.B. 780

<sup>62</sup> Rev. Proc. 89-13, 1989-1 C.B. 801

able to retain their prototype status and reliance following changes in the law if certain requirements were met.<sup>63</sup> Additionally, the regional prototype plan was intended to increase flexibility for Adopting Employers and provide reciprocity among IRS regions once a plan was approved in one region.<sup>64</sup> A sponsor of a regional prototype plan was defined as a firm<sup>65</sup> which “(1) has an established place of business in the United States where it is accessible during every business day, and (2) either has at least 30 clients that have their principal place of business within the jurisdiction of not more than two regions of the IRS and are expected to adopt the sponsor’s regional prototype plan, or has at least three clients that are expected to adopt a ‘mass submitter regional prototype plan.’”<sup>66</sup>

The regional prototype plan program and the M&P plan program operated separately, each being amended a number of times thereafter as procedural requirements changed in accordance with the law, until the two were finally unified under a single M&P plan program in 2000.<sup>67</sup> Stating that it was no longer practical to maintain separate programs, the IRS issued Rev. Proc. 2000-20, setting forth the “Unified Program,” creating one set of requirements and procedures for all M&P plan sponsors and expanding the availability of options previously available to only one program to make them universally available under the Unified Program.<sup>68</sup> The Unified Program dispensed with the additional requirements that were formerly applied to M&P plans sponsored by trade or professional organizations, expanded sponsorship eligibility to include the criteria under both the M&P plan program<sup>69</sup> and the regional prototype program,<sup>70</sup> and allowed any person with an established place of business in the U.S. to sponsor an M&P plan that was identical or a minor modification of a mass submitter

---

<sup>63</sup> *Id.* at §3.01

<sup>64</sup> *Id.*

<sup>65</sup> “[A] partnership or corporation at least one of whose members or employees is authorized to practice before the Internal Revenue Service with respect to employee plans matters, or an individual who is so authorized.” *Id.* at § 4.03

<sup>66</sup> *Id.* at §4.02

<sup>67</sup> Rev. Proc. 2000-20, 2000-1 C.B. 553

<sup>68</sup> As way of example, the Revenue Procedure explains that while M&P sponsors were previously allowed to sponsor paired defined benefit and defined contribution plans, regional prototype sponsors could not, but under the Unified Program, all sponsors can sponsor paired defined benefit and defined contribution plans. *Id.* at § 3.04

<sup>69</sup> Rev. Proc. 89-9, 1989-1 C.B. 780

<sup>70</sup> Rev. Proc. 89-13, 1989-1 C.B. 801

plan, regardless of how many employers were expected to adopt the plan.<sup>71</sup> Yearly notices to the IRS and each Adopting Employer, previously required of Sponsoring Organizations,<sup>72</sup> were eliminated and replaced with a simplified requirement that all M&P plan Sponsoring Organizations maintain a list of Adopting Employers and that Sponsoring Organizations supply the list to the IRS upon request.<sup>73</sup> The Unified Program also made uniform the Mass Submitter program by creating a single definition of a mass submitter as any person who could establish that at least 30 unaffiliated adopting sponsors would adopt the basic plan document, while allowing those mass submitters who obtained an opinion letter as a mass submitter of M&P plans under Rev. Proc. 89-9<sup>74</sup> to generally qualify as a mass submitter under the Unified Program.<sup>75</sup> Finally, as was previously the case for standardized M&P plans, under the Unified Program, opinion letters issued for all standardized plans, including regional prototype plans, could be relied upon by an Adopting Employer except in certain situations.<sup>76</sup>

Despite the unification of procedures that was occurring during that period, the VS program remained separate. The VS program emerged in the 1980s and was first addressed by the IRS in Rev. Proc. 89-4.<sup>77</sup> A VS plan was a “pension, profit-sharing or stock bonus plan, the form of which met certain criteria established by an individual key district and which was submitted pursuant to procedures established by the key district for filing determination letter applications under the district’s VS program.”<sup>78</sup> Pursuant to the program, a practitioner could submit a “lead” or “specimen” plan only if he could certify at the time of the submission that in the future he would submit no fewer than 30 determination letter requests on behalf on employers who have adopted a plan substantially identical to the lead plan.<sup>79</sup> Unlike M&P plans, VS plans allowed the Sponsoring Organization to delete any plan provisions from the lead plan that did not

---

<sup>71</sup> Rev. Proc. 2000-20 at §3.06

<sup>72</sup> Rev. Proc. 89-13 at §14.05

<sup>73</sup> Rev. Proc. 2000-20 at §3.07

<sup>74</sup> “[A]ny person that received a favorable TRA ‘86 opinion letter for a plan as a mass submitter under Rev. Proc. 89-9 will continue to be treated as a mass submitter if it submits applications on behalf of at least 10 sponsors (regardless of affiliation) each of which is sponsoring, on a word-for-word identical basis, the same basis plan document and one or more of the adoption agreements associated with that plan document.” Rev. Proc. 2000-20 at §4.10

<sup>75</sup> Rev. Proc. 2000-20 at §3.08

<sup>76</sup> *Id.* at § 6

<sup>77</sup> 1989-1 C.B. 767

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at §6.02

apply and were generally more compact and simpler to use than their M&P counterparts.<sup>80</sup> While the VS program was maintained through separate programs at each Key District Office, it was centralized in 1998, and all VS specimen plans were required to be filed with the Volume Submitter Coordinator in the Ohio Key District Office.<sup>81</sup>

Since 2000, there have been minor amendments to the Unified Program, most notable of which was in 2005, when the IRS issued Rev. Proc. 2005-16, attempting to simplify and combine the otherwise separate programs for PAPs.

### **B. Current Requirements for Pre-Approved Plans**

Rev. Proc. 2005-16 sets forth the IRS' current procedures for issuing opinion and advisory letters regarding the qualification of PAPs under Sections 401(a) and 403(a) of the Code.<sup>82</sup> It delineates the requirements and responsibilities of Sponsoring Organizations and Adopting Employers in connection with the establishment, qualification and operation of PAPs.

Some differences between an M&P plan and a VS plan continue under Rev. Proc. 2005-16.<sup>83</sup> An M&P plan generally consists of a basic plan document and an Adoption Agreement, with no amendments permitted except for choosing among options permitted in the Adoption Agreement. A VS plan may consist of a basic plan document and Adoption Agreement or a single plan document (referred to as an individually-designed format) that can be amended on a limited basis as long as the extent and complexity of the amendments are not inconsistent with the purposes of the VS program. The Rev. Proc. expanded the program so that it can apply to a greater number of practitioners sponsoring VS plans ("VS Practitioners") and M&P Plan Sponsoring Organizations who would like to participate in PAP programs and allows somewhat more flexibility by specifying provisions that can be amended without

---

<sup>80</sup> Steven J. Franz et al., 401(k) Answer Book 3-4 (2005 ed.)

<sup>81</sup> Rev. Proc. 98-6, 1998-1 I.R.B. 183

<sup>82</sup> The Service maintains two separate programs- the M&P Program and VS Program. Under Rev. Proc. 2005-16, the Service states that "the narrowing of the differences between the programs makes it appropriate to set forth the rules for both programs in a single revenue procedure." Rev. Proc. 2005-16at §3.01

<sup>83</sup> The ACT considered a recommendation to eliminate all distinctions between the two programs. While it recognizes the historical aspects of each program, it has observed that certain complexities (and resulting plan failures) concerning M&P plans could be eliminated, if all pre-approved plans were granted the flexibility provided in a VS plan.

jeopardizing qualification of the plan.<sup>84</sup> Two of the most significant changes brought about by Rev. Proc. 2005-16 include the ability of Adopting Employers with non-standardized M&P plans to adopt an allocation formula designed to be cross-tested for nondiscrimination on the basis of equivalent benefits under § 1.401(a)(4)-8 of the Code and the ability of VS Practitioners to amend VS plans on behalf of Adopting Employers.<sup>85</sup>

## 1. M&P Plans

### (a) Plan Document Requirements

Section 5 of the Rev. Proc. generally contains a description of the provisions that must be included in every M&P plan document and Adoption Agreement. For example, Section 5.01 requires the plan to provide a procedure for the Sponsoring Organizations to adopt amendments to the plan documents so that changes in the Code, regulations, revenue rulings and other guidance issued by the IRS, or corrections of prior plan documents may be implemented on behalf of all Adopting Employers, without any affirmative action on their part.

Certain plan document requirements (anti-cutback provisions and top-heavy requirements) are applicable to all M&P plans, while others are only applicable to standardized (i.e., no last day rule permitted for receiving a contribution) or non-standardized plans (i.e., the plan must provide for a "total compensation" definition option). As noted previously, standardized plans are plans that by design must meet the Code's eligibility, contribution or benefit, and non-discrimination requirements, thereby assuring its Adopting Employers of "reliance" without the need for an individual determination letter.<sup>86</sup> Non-standardized plans are any M&P plans that are not a standardized plan.<sup>87</sup>

In the event of changes in the qualification requirements resulting from legislation or regulatory guidance issued by the IRS, M&P plans must be amended by the Sponsoring Organization to retain M&P status and, if necessary, also by the Adopting Employer to retain the plan's qualified status. Generally, the IRS announces

---

<sup>84</sup> Rev. Proc. 2005-16 at §4.10

<sup>85</sup> *Id* at §4.11

<sup>86</sup> *Id* at §4.10

<sup>87</sup> *Id* at §4.11

the date by which the M&P plan must be amended by the Sponsoring Organization and if necessary by the Adopting Employer.

(b) M&P Adoption Agreement

The Adoption Agreement is the portion of the M&P plan that contains basic information about the plan and the Adopting Employer, as well as the variable or optional provisions selected by the Adopting Employer. The Rev. Proc. delineates certain Adoption Agreement requirements for all M&P plans and others that are applicable to only standardized or non-standardized M&P plans.

All M&P Adoption Agreements must:<sup>88</sup>

- include a dated Adopting Employer signature line;
- state that it can be used with one and only one specific basic plan document;
- contain a cautionary statement to the effect that the failure to properly fill out the Adoption Agreement may result in the failure of the plan to qualify;
- contain a statement that provides that the Sponsoring Organization will inform the Adopting Employer of any amendments made to the plan or of the discontinuance or abandonment of the plan; and
- include the Sponsoring Organization's name, address and telephone number for inquiries by Adopting Employers regarding the adoption of the plan, the meaning of plan provisions, or the effect of the opinion letter.

Additionally, every M&P Adoption Agreement must include, in close proximity to the signature blank, a statement that describes the limitations of employer reliance on an opinion letter without a determination letter and the circumstances under which an Adopting Employer will have no reliance without a determination letter. The limitations for standardized and non-standardized plans are different and, as such, each must have its own cautionary statement.<sup>89</sup>

---

<sup>88</sup> *Id* at §5.11 and §5.12. See also, Defined Contribution Listing of Required Modifications and Information Package (LRM) issued August 2005, question 85.

<sup>89</sup> *Id* at §5.10. See also, Defined Contribution Listing of Required Modifications and Information Package (LRM) issued August 2005, questions 90 and 92.

(c) M&P Sponsor Recordkeeping and Notification Requirements

The Rev. Proc. prescribes a series of record keeping and notification requirements for Sponsoring Organizations in order to obtain an opinion letter and maintain an M&P plan. These requirements are generally designed to assure that a Sponsoring Organization keeps its Adopting Employers apprised of plan document changes and, when necessary, appropriate action is taken by an Adopting Employer. These requirements include:

- making reasonable and diligent efforts to ensure that each Adopting Employer which, to the best of its knowledge, continues to maintain the plan as an M&P plan, amends its plan when necessary;<sup>90</sup>
- making reasonable and diligent efforts to ensure that Adopting Employers have actually received and are aware of all plan amendments and that such Adopting Employers complete and sign new Adoption Agreements when necessary;<sup>91</sup>
- furnishing each Adopting Employer with a copy of the approved plan, subsequent amendments, and the most recently issued IRS opinion letter;<sup>92</sup>
- notifying each Adopting Employer that a request for an opinion letter has been withdrawn and that the Adopting Employer will be deemed to have an IDP;<sup>93</sup>
- maintaining, for each of its plans, a record of the names, business addresses, and taxpayer identification numbers of all Adopting Employers that have adopted the plan. The Sponsoring Organization need not maintain records for Adopting Employers that, to the best of its knowledge, ceased to maintain the plan as an M&P plan more than three years earlier. Upon written request, a Sponsoring Organization must provide this list to the IRS;<sup>94</sup>

---

<sup>90</sup> *Id.* at §8.02  
<sup>91</sup> *Id.* at §5.01  
<sup>92</sup> *Id.* at §7.06  
<sup>92</sup> *Id.* at §9.01  
<sup>93</sup> *Id.* at §9.01  
<sup>94</sup> *Id.* at §11.02

- notifying the Adopting Employers that its plan may no longer be qualified, the adverse tax consequences that may result from loss of the plan's qualified status, and the availability of EPCRS if the Sponsoring Organization reasonably concludes that an Adopting Employer's M&P plan may no longer be a qualified plan;<sup>95</sup>
- notifying the IRS in writing of an approved M&P plan that is no longer used by any Adopting Employer and which the Sponsoring Organization no longer intends to offer for adoption;<sup>96</sup>
- informing each Adopting Employer that the form of the plan has been terminated, that the plan will become an IDP (unless the employer adopts another approved M&P plan), and that any reliance will not continue if there is a change in law or other change in the qualification requirements, if a Sponsoring Organization intends to abandon its M&P plan; and after informing all Adopting Employers, also notifying the IRS in writing;<sup>97</sup> and
- notifying the Adopting Employers of the revocation of its opinion letter and how the revocation affects any reliance on the previously issued opinions.<sup>98</sup>

The Rev. Proc. further provides that a Sponsoring Organization's failure to comply with any requirement delineated, including the notice and recordkeeping requirements, may result in the loss of the ability to maintain an M&P plan or the revocation of an existing opinion letter. As noted hereinafter, the ACT is unaware of any IRS audit program designed to determine a Sponsoring Organization's level of compliance, or any sanction taken against a Sponsoring Organization for any failure.

(d) M&P Plan Adopting Employers

Under the Rev. Proc., the requirements for Adopting Employers generally consist of following the procedures provided by the Sponsoring Organization with regard to plan documents, amendments and operation. Adopting Employers must complete and sign the Adoption Agreement upon first adopting the plan, complete and sign a new

---

<sup>95</sup> *Id.* at §8.05

<sup>96</sup> *Id.* at §10.01

<sup>97</sup> *Id.* at §10.02

<sup>98</sup> *Id.* at §22

Adoption Agreement if the plan has been restated and complete and sign a new signature page if modifications of any prior elections are made in the Adoption Agreement. Additionally, Adopting Employers must follow directions provided by the Sponsoring Organization with regard to the timely adoption of amendments to comply with new legislation and new guidance issued by the IRS. Regardless of when amendments are required to be made, Adopting Employers must operationally comply, as of the applicable effective date, with such legislation and guidance.

## **2. Volume Submitter Plans**

### **(a) Plan Document Requirements**

As noted above, a VS plan may either take the form of a single integrated document or an Adoption Agreement paired with a basic plan document. Many of the plan provisions required for M&P plans are also required in VS plans.<sup>99</sup> Additionally, VS Practitioners are required to amend their specimen document from time to time to comply with legislative changes, and if necessary, the Adopting Employer must also adopt the amendment to maintain the plan's qualified status. The principal difference between the VS and M&P programs is the ability of Adopting Employers to modify provisions that are contained in the VS specimen document or include additional provisions that were not in the VS specimen document and still qualify as a VS plan.<sup>100</sup>

A VS plan may, but is not required to, include a provision that authorizes the VS Practitioner to amend the plan on behalf of Adopting Employers, without affirmative action on their part, so that changes in the Code, regulations, revenue rulings, other statements published by the IRS (including model, sample or other required good faith amendments that specifically provide that their adoption will not cause such plan to be individually designed), or corrections of prior approved plans may be applied to those Adopting Employers. By taking this action, as noted below, the VS Practitioner subjects itself to substantially greater notice and recordkeeping responsibilities.

### **(b) VS Practitioner Recordkeeping and Notification Requirements**

<sup>99</sup> *Id.* at §14

<sup>100</sup> Form 5307, Application for Determination for Adopters of Master or Prototype or Volume Submitter Plans provides that the form may not be used if the Adopting Employer of an M&P plan amends the plan other than through the choice of elections offered in the Adoption Agreement (and thus be considered an IDP). On the other hand, the form further provides that in the case of a VS plan, the Adopting Employer must submit a written statement which delineates any modifications made to the VS specimen plan (and thus retain its VS status).

Generally, VS Practitioners have few ongoing obligations with respect to their Adopting Employers, although “good practice” dictates that they continue to apprise Adopting Employers of required plan changes. In instances, however, where the VS Practitioner’s plan provides a right of the VS Practitioner to adopt plan amendments on behalf of their Adopting Employers, the Rev. Proc. now imposes on the VS Practitioner substantially the same notification and recordkeeping requirements as those delineated in Section IV.B.1(c) above with regard to M&P plans.<sup>101</sup>

## V.

### **DATA GATHERING PROCESS**

Through anecdotal evidence and the observations of ACT members<sup>102</sup> at the outset of this project, it was believed that adopters of PAPs generally maintained lower levels of compliance than adopters of IDPs. The ACT, however, recognized that it could not rely upon its own experiences and observations, but instead should obtain independent verification to sustain this premise. Ideally, empirical data already existed or could be developed. Unfortunately, the ACT quickly determined that neither the IRS nor any other constituency could provide statistical information.

The ACT then concluded that the best available evidence would have to be gathered through a process which engaged the members of each of the PAP constituencies and obtained focused anecdotal evidence of the most frequent plan failures they encountered and their recommendations for improving compliance. As discussed below, the collection of background information focused on three communities involved in the design, operation and regulation of PAPs, including (1) Sponsoring Organizations, (2) Adopting Employers and practitioners who assist them in the adoption process and/or administration of their plan, and (3) the IRS. The following is a summary of the ACT’s data gathering efforts:

#### **A. Sponsoring Organizations**

The ACT believed that Sponsoring Organizations would be the community best able to provide information and help provide suggestions for formulating recommendations. To that end, on October 23, 2006, the ACT met in Washington with representatives of 13

---

<sup>101</sup> Rev. Proc. 2006-16 at §15.06

<sup>102</sup> The ACT project members are all experienced retirement plan practitioners.  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

institutional organizations.<sup>103</sup> Entities that attended included brokerage firms, insurance companies, mutual fund companies, trade associations, third party administrators, and benefits counsel. With a broad cross section of attendees, the ACT recognized that Sponsoring Organizations were keenly sensitive to the issues related to the ACT's project. While the participants expressed numerous and varied concerns regarding the M&P program, including very thoughtful technical comments regarding the operation of M&P plans, certain basic themes, which are discussed below, emerged from the discussion.

### **B. Adopting Employers and Practitioners**

The ACT considered it important to solicit information from Adopting Employers of PAPs. Unfortunately, this proved extremely difficult. To directly reach Adopting Employers, the ACT placed an article in the EP's *Retirement News for Employers*. The article simply inquired about the assistance Adopting Employers received in adopting and administering their PAPs, the difficulty they encounter in complying with the IRS' requirements and any recommendations they would make to improve the PAP system. Only three responses were received and none provided a sufficiently meaningful comment or recommendation to be relied upon.

As an alternative to a direct solicitation of the views of Adopting Employers, the ACT approached various organizations representing small businesses to determine if they either had empirical data of their own or would allow the ACT to survey its membership with respect to their experiences with PAPs. Here again, the ACT failed to find an effective means of surveying Adopting Employers due to the reluctance of these organizations to grant the ACT access to its membership.

At this juncture, the ACT determined that the next most effective means of surveying this constituency would be to survey practitioners who assist Adopting Employers in adopting and administering PAPs. To that end, the ACT posted a survey on the BenefitsLink<sup>104</sup> web site (the survey and results are available at

---

<sup>103</sup> The ACT extends its gratitude to the representatives of Association for Advanced Underwriting, Capital Research & Management Co., Fidelity, Investment Company Institute, Merrill Lynch, NTSAA, Oppenheimer Funds, Principal Financial Insurance Co., Prudential, Retirement Plan Resources, Securities Industry Association, The Vanguard Group, and Wolff, Block, Schorr and Solis-Cohn, LLP for their assistance in providing information and insight used in the preparation of this report.

<sup>104</sup> The ACT extends its gratitude to Dave Baker of BenefitsLink, who assisted with the publication of this survey and the tabulation of its results.

<http://benefitslink.com/cgi/surveys/act-survey-results.cgi>). BenefitsLink is a web site that caters to the employee benefits community. It is a widely recognized source of benefits information and also offers a forum for discussion and analysis of various retirement plan related issues. The site is generally frequented by professionals who provide legal counsel or administrative and testing services to Sponsoring Organizations, as well as employers maintaining qualified retirement plans.

In order to survey this group, the ACT developed and posted three simple questions.

- What are the most common plan failures you encounter, when Adopting Employers utilize a PAP?
- Do you believe that plan failures are less likely to occur, just as likely to occur, or more likely to occur when Adopting Employers utilize a PAP?
- What recommendations do you have for improving compliance and reducing the most common plan failures for Adopting Employers utilizing PAPs?

110 individuals responded to the ACT's survey. While most of the responders were not Adopting Employers, the practitioners who did respond were professionals who work closely with such employers and were therefore familiar with the issues confronting them.

### **C. The IRS**

Finally, the ACT solicited the views of the IRS. This process involved holding in-depth interviews with senior members of the EP leadership team,<sup>105</sup> the leadership of the EP Determinations Group and the manager of the EPCU group,<sup>106</sup> as well as surveying EP audit agents as to their views. The ACT met with senior EP personnel on July 31 and August 1, 2006 and with the EP Determinations Group on January 8, 2007.

---

<sup>105</sup> The ACT extends its gratitude to Carol Gold, Former Director, Employee Plans; Joseph Grant, Director, Employee Plans; Michael Jullianelle, Former Director, EP Examinations; Mark O'Donnell, Director, EP Customer Education & Outreach; Martin Pippins, Manager, EP Technical Guidance & Quality Assurance; and Joyce Kahn, Manager, EP Voluntary Compliance for the assistance they provided in gathering data and information used in the preparation of this report.

<sup>106</sup> The ACT extends its gratitude to Craig Chomyok, Manager EPCU for the assistance he provided in the preparation of this report.

While PAPs are regularly subject to EP Audits, the IRS does not maintain empirical data that compares compliance levels of PAPs to IDPs.<sup>107</sup> Also, the IRS does not currently maintain, nor has it historically maintained audit programs focused on issues unique to PAPs and their Sponsoring Organizations. Furthermore, the IRS does not separately track PAPs and IDPs submitted under the VCP program. Based upon the discussions with the EP leadership team, the ACT determined that additional data could be obtained through a survey of EP audit agents. To that end, a questionnaire similar in nature to the BenefitsLink survey was developed and distributed to these agents. The ACT received 33 responses,<sup>108</sup> most of which provided thoughtful and helpful responses.

## VI.

### **FINDINGS AND CONCLUSIONS**

#### **A. General Observations and Recommendations of the Constituencies**

##### **1. From Senior IRS Personnel Interviews:**

The following general observations and recommendations were received from senior IRS personnel during interviews by ACT members:

- It is critical that Adopting Employers understand their own responsibilities and the role and responsibilities of the Sponsoring Organization and service providers (such as the TPA, record keeper, attorney, accountant, etc.).
- Each Sponsoring Organization and service provider should better communicate with the Adopting Employers concerning their roles and responsibilities.
- The role and responsibilities of each Sponsoring Organization and service provider should be clarified at the time of the adoption of the plan by the Adopting Employer.

---

<sup>107</sup> The IRS reported that in 2005, it closed approximately 9,000 EP audit cases, 40% of which involved M&P plans. The IRS also indicated that this percentage may not be accurate since these results reflect employer designations on the Form 5500 which are often not accurate.

<sup>108</sup> The ACT extends its gratitude to these EP Agents who participated in its survey and their contribution to this report.

- Some compliance problems may result from the Sponsoring Organization's failure to comply with obligations established in Rev. Proc. 2005-16.
- The IRS has never conducted a focused audit of Sponsoring Organizations to determine if they are compliant with the requirements of Rev. Proc. 2005-16.
- While some Sponsoring Organizations may try to sell PAPs as a "complete package," certain administrative responsibilities may not be addressed (e.g., determining eligibility of participants).
- Sponsoring Organizations often "oversell" the services they will be providing to Adopting Employers, leading Adopting Employers to believe they have no compliance responsibilities.

## **2. From Sponsoring Organization Representatives**

The following general observations and recommendations were received from the Sponsoring Organization representatives during the October 23, 2006 meeting with ACT members:

- Adopting Employers need competent assistance in completing the M&P Adoption Agreements and other plan documents; however, many Adopting Employers either cannot afford or do not want to spend the money to obtain such assistance.
- In the retail market – a term used by Sponsoring Organizations to mean small plans (e.g., less than 10 participants) – there is little, if any, interaction between the Adopting Employers and them.
- Adopting Employers typically lack the knowledge to understand how to operate and comply with their plan documents and the law governing them.
- The rules governing PAPs and the plans' terminology are often too technical or cumbersome for small employers, and as such, employers need education and training to better understand the legal requirements, their plan, and its administration.

- There is not enough flexibility in the M&P plan system to allow Sponsoring Organizations to continue handling plans once they are amended in a manner which takes them out of M&P status, even if the amendment is only minor.
- Where a controlled group member ceases to be part of the controlled group, there is uncertainty on how to handle this situation, since M&P plans are not available for multiple employer groups. Moreover, Adopting Employers are often unaware of whether a controlled group exists or not, making this issue even more pronounced when it comes to light.
- Records and data are often unavailable, making compliance difficult or impossible. This is particularly true with inherited plans, or where the prior Sponsoring Organization no longer exists.
- The new staggered remedial amendment system is too complex for most Adopting Employers and may lead to increased noncompliance, since Adopting Employers will not understand the various rules related to timing and interim amendments.
- More PAP options should be available for non-ERISA plans.
- Further IRS guidance is needed by Sponsoring Organizations concerning their responsibilities for situations where their Adopting Employers encounter document or operational failures.

### **3. Summary of Survey Results**

Inasmuch as each of the questions in the two ACT surveys was “open-ended,” the responses that were received were widely dispersed. Within each of the constituencies, certain responses did appear more prevalent than others. In some instances, the responses were consistent from constituency to constituency, while in other instances that was not the case.

(a) Most Common Failures

The following represents the most common plan failures identified with respect to adopters of PAPs (starting with the most frequently identified failure and listing them in descending order):

The IRS Audit Agent Group<sup>109</sup>

- ADP/ACP failures
- Non-amenders/late amenders
- Eligibility failures
- Vesting and/or forfeiture failures
- Contribution allocation failures
- Failures based upon the definition of compensation

The Practitioner Group<sup>110</sup>

- Eligibility failures
- Failures based upon the definition of compensation
- Non-amenders/late amenders
- Failures to follow plan documents
- Late 401(k) deposits
- Participant loan failures

While there was agreement among these groups with respect to eligibility failures, plan amendment failures, and issues concerning the definition of compensation, there were also significant discrepancies regarding other failures. For example, the IRS audit agent group identified ADP/ACP failures as the most significant failure they encountered, while few members of the practitioner group considered this to be significant. On the other hand, the practitioner group identified such items as late 401(k) deposits and the failure to follow plan documents as frequently encountered failures, while the IRS audit agent group did not identify these to be significant problems for PAP adopters.

---

<sup>109</sup> See Exhibit A for data. It should be noted that the information shown on Exhibit A reflects only those issues identified by the agents on those audits and may not include other common errors.

<sup>110</sup> See Exhibit B for data.

(b) Frequent Failures in PAPs

With respect to the question of whether the identified plan failures were more likely to occur in a PAP than in an IDP, the following results were noteworthy:

The IRS Audit Agent Group<sup>111</sup>

- ADP/ACP failures – 30% felt they were more likely to occur in a PAP than an IDP
- Non-amenders/late amenders – 44% felt they were more likely to occur in a PAP than an IDP
- Eligibility failures – 38% felt they were more likely to occur in a PAP than an individually designed plan

With respect to all identified failures, the IRS Audit Agent Group believed that 10% of the failures were less likely to occur in a PAP; 53% of the failures were just as likely to occur in a PAP; and 37% of the failures were more likely to occur in a PAP.

The Practitioner Group<sup>112</sup>

- Eligibility failures – 23% felt they were more likely to occur in a PAP than in an IDP.
- Failures based upon the definition of compensation – 40% felt they were more likely to occur in a PAP than in an IDP.
- Non-amenders/late amenders – 55% felt they were more likely to occur in a PAP than in an IDP.

With respect to all identified failures, the practitioner group believed that 6% of the failures were less likely to occur in a PAP; 55% of the failures were just as likely to occur in a PAP; and 39% of the failures were more likely to occur in a PAP.

In light of these findings, which are observations of a limited number of IRS audit agents and practitioners, no conclusion can be reached that adopters of PAPs are more likely to encounter a plan failure than the adopters of an IDP. However based upon the information gathered by the ACT, it is noted that a significant percentage of the IRS agents and practitioners who responded to its inquiry, believe that certain plan failures are more likely to occur in PAPs than IDPs.

(c) Recommendations

---

<sup>111</sup> See Exhibit A for data.

<sup>112</sup> See Exhibit B for data.

The last inquiry made by the ACT was simply a request for recommendations to improve compliance for Adopting Employers of PAPs. The following represents a summary of the most frequent responses (starting with the most frequently identified recommendation and listing them in descending order):

The IRS Audit Agent Group

- Adopting Employers should have a better understanding of how their plan operates.
- Sponsoring Organizations should have increased responsibilities to ensure that documents are updated timely and the plan administration handled appropriately.
- The IRS should increase its education and outreach efforts.
- Adopting Employers should be encouraged to seek out and retain competent assistance in the administration of their plan.
- A summary of pertinent plan provisions and/or a summary of the responsibilities to be provided by the Adopting Employer, service providers, and other professionals should be completed and maintained as a part of the plan document.

The Practitioner Group

- Plan documents should be simplified to the extent possible. This includes simplifying Adoption Agreements and requiring Adoption Agreements and plan documents to be written in “plain English.”
- Adopting Employers should be encouraged to seek out and retain competent assistance in the administration of their plan.
- Adopting Employers should have a better understanding of how their plan operates.
- Sponsoring Organizations should have increased responsibilities to ensure that documents are updated timely and the plan administration handled appropriately.
- The amendment process should be simplified by reducing the number of required amendments.

## **B. Conclusions**

The ACT believes that the PAP system can be improved through realistic and workable recommendations, which assist each of the constituencies participating in the PAP in discharging its responsibilities. With this background, the ACT has learned that Adopting Employers often do not understand the most essential elements of their plans. For example, Adoption Agreement failures often occur due to missing information, the failure to understand the implications of the options being selected, inconsistencies with prior Adoption Agreements when moving to a new Sponsoring Organization or the failure to timely amend when required. Furthermore, Adopting Employers often fail to understand their responsibilities for the maintenance of these plans, as well as the responsibilities of its service providers and professionals. Finally, Adopting Employers often fail to appreciate the consequences of their failure to operate the plan in conformity with plan documents and the requirements of the IRS and other government agencies.

The ACT has further learned that plan failures often occur due to inadequate resources and personnel required for an Adopting Employer to maintain a qualified retirement plan (or at least the type of plan they have adopted). Additionally, plan failures occur because of the failure of Sponsoring Organizations to apprise Adopting Employers of the complexities of the plan and their respective responsibilities. Finally, plan failures occur because Adopting Employers fail to utilize the services of competent and knowledgeable service providers and professionals.

## **VII.**

### **RECOMMENDATIONS**

#### **A. Increased Responsibilities for Sponsoring Organizations**

##### **1. Acknowledgement and Information Form**

The ACT recommends that the IRS require M&P plan Sponsoring Organizations to include on a separate page, attached to the Adoption Agreement as the first page, an Acknowledgement and Information Form.<sup>113</sup> The purpose of this form is generally to (i) advise an Adopting Employer of the requirements for adopting a PAP

---

<sup>113</sup> Attached as Exhibit C is a sample Acknowledgement and Information Form as contemplated by the ACT.  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

(including providing the Adopting Employer with a copy of the special IRS Publication referred to in VII.B.2. below, when issued by the IRS) and (ii) include a list of the parties responsible for performing various administrative functions on behalf of the plan.

This form should include:

- An acknowledgement that the Adopting Employer has received copies of the basic plan and trust documents from the Sponsoring Organizations.
- An acknowledgement that the Adopting Employer has completed and executed the Adoption Agreement.
- A list of parties responsible for performing the following functions:
  - Preparation of plan documents and summary plan descriptions.
  - Preparations of annual reports (Form 5500 series).
  - Record keeping.
  - Plan administration (i.e., allocations of contributions, non-discrimination testing, benefits statements, etc.)
  - Trusteeship.
- A prominent notice of availability of information on the IRS web site and/or IRS newsletters.
- Such other information that the IRS deems appropriate.

The ACT believes that many plan failures result from Adopting Employers not understanding their own responsibilities and the responsibilities of service providers/professionals. While it is recognized that these responsibilities will shift over time, it will make Adopting Employers, at least initially and from time to time thereafter, focus on administration and understand the various parties' responsibilities.

## **2. Simplified M&P Plans**

The ACT recommends that each Sponsoring Organization of an M&P plan be required to offer a "simplified" version with few or no options.<sup>114</sup> The objective of this recommendation is to simplify plan documents for many Adopting Employers in order to minimize document non-compliance. The ACT believes that many document failures

---

<sup>114</sup> Although the ACT understands that since the enactment of EGTRRA, many financial institutions offer single participant 401(k) plans (commonly referred to as EZ-Ks, Solo-Ks, and Uni-Ks) which are "simplified" documents, it is the recommendation of the ACT that all Sponsoring Organizations of PAPs be mandated to offer a type of "simplified" document.

occur in M&P plans simply because the only Adoption Agreement made available by a Sponsoring Organization is far too complicated and contains too many options for the smallest of Adopting Employers. The IRS also should determine whether it is advisable and feasible for them to prescribe standard terms for these plans.

### **3. Document Retention Policy**

The ACT recommends that the IRS impose a document retention policy as part of Rev. Proc 2005-16. The policy should require Sponsoring Organizations of M&P plans to retain and make available upon request of Adopting Employers copies of their own plan documents and opinion letters, along with all amendments, for an indefinite period of time, or for such shorter periods of time as the IRS determines appropriate. The ACT believes that some Sponsoring Organizations do not maintain prior plan documents, which becomes problematic when an Adopting Employer moves to a new Sponsoring Organization and prior plan documents cannot be located.

## **B. IRS Education and Outreach for Adopting Employers**

### **1. Use of IRS Newsletters**

The IRS maintains on its web site a section devoted to the retirement plans community. One of the items provided within that section is a link to its quarterly publication entitled “*Retirement News for Employers.*” While this newsletter provides valuable information to employers who have adopted a retirement plan, little of the content is devoted to employers who utilize a PAP. The ACT believes that these employers need information that is designed specifically for them. Accordingly, the ACT recommends that either the IRS develop a PAP newsletter that is a stand-alone document or if that is not feasible, a regular page or column in the *Retirement News for Employers*, devoted to the Adopting Employer community. The type of issues that could be addressed would include: an Adopting Employer’s legal responsibilities, plan amendment requirements, audit checklists, and commonly-found compliance errors. Circulation of the newsletter could be enhanced by requiring Sponsoring Organizations to enter subscriptions for new Adopting Employers.<sup>115</sup> The ACT strongly believes that one of the most effective means of educating Adopting Employers about their

---

<sup>115</sup> The ACT recognizes that the current system requires the Employer to accept the confirmation email after the subscription is entered.

responsibilities in maintaining a retirement plan is to provide them with regular, understandable and "high quality" information through newsletters and the IRS web site and to make them aware of these resources. In this regard, the ACT further recommends that the IRS make every reasonable effort to dramatically increase the circulation of the *Retirement News for Employers* for Adopting Employers.<sup>116</sup>

## **2. Special IRS Publication for Adopting Employers**

The ACT believes that many of the document failures that arise in the preparation of M&P plan documents result from the preparer having insufficient knowledge or expertise to understand the intricacies related to the options available under the plan. The ACT recognizes that the preparer may be a representative of the Sponsoring Organization or the Adopting Employer itself. Thus, the ACT recommends that the IRS produce a special publication for Adopting Employers and other document preparers assisting employers in adopting M&P plans which would include, such things as: (i) information regarding the completion of an Adoption Agreement or development of the plan, (ii) special requirements to obtain a determination letter, if the plan is a non-standardized M&P plan, and (iii) special considerations if it is an amendment of a pre-existing plan. The IRS should require that, at the time of the adoption of an M&P plan, whether the adoption initially establishes the plan or is an amendment and restatement of a pre-existing plan, the Sponsoring Organization distribute the publication to the Adopting Employers and any other document preparer who is known by the Sponsoring Organization.

## **3. Self-Audit Checklist**

In recent years the IRS has successfully developed and made available a series of "self audit" checklists. These include checklists for 401(k) plans, 403(b) plans, SEPs, SIMPLE IRA plans, and SARSEPs. The ACT recommends that the IRS establish a checklist to be used by Adopting Employers to "self-audit" their plans. For example, such checklist may highlight the proper completion of the Adoption Agreement, maintenance of timely amendments, providing copies of the Summary Plan Description to employees, etc.

## **4. Specialized Web Site**

---

<sup>116</sup> As of March 19, 2007, the IRS reported 9,595 subscriptions to its *Retirement News for Employers*.  
Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007

The ACT recommends that the IRS develop a web site for Adopting Employers similar to the online training web site it has created for tax-exempt organizations entitled "Stay-Exempt-Tax Basics for 501(c)(3)s" ([www.stayexempt.org](http://www.stayexempt.org)). It is the ACT's belief that this type of educational tool, if properly advertised to the Adopting Employer community, will assist these employers in understanding their responsibilities and complying with the requirements imposed on PAPs.

### **C. Other Recommendations**

#### **1. IRS Audit Functions**

The ACT understands that a project is being undertaken by the Employee Plans Compliance Unit to initiate a limited number of "soft contacts" with Sponsoring Organizations in order to determine if those Organizations are complying with the various requirements of Rev. Proc. 2005-16. The ACT applauds the IRS's efforts in this regard and recommends that after the guidance described in Sections VII.A and VII.C.3 has been provided, the IRS make the examination of Sponsoring Organizations a permanent part of its compliance efforts.

#### **2. Use of M&P Plans by Multiple Employer Groups**

The ACT has observed that an inordinate number of plan failures occur when either commonly controlled groups of Adopting Employers utilizing M&P plans lose controlled group status through "shifts" of ownership, or when a plan is mistakenly adopted by a group of employers not meeting the definition of a controlled group. Currently Rev. Proc. 2005-16 prohibits the use of M&P plans by multiple employer groups not under common control. As such, the ACT recommends that the IRS should modify and expand Rev. Proc 2005-16 to permit non-commonly controlled, multiple-employer groups to adopt M&P plans and to revise LRMs to include appropriate sample language.

#### **3. Publication of Additional Guidance**

During its October 23, 2006 meeting with Sponsoring Organization representatives, the ACT learned that many in attendance believed that further guidance beyond that contained in Rev. Proc. 2005-16 was needed to better clarify their responsibilities. Specifically they requested clarification of their obligations (i) in connection with Adopting Employers who do not respond to amendments and other

information requests sent by the Sponsoring Organizations, or (ii) where the Sponsoring Organization has a reasonable belief that there may have been document or operational failures by an Adopting Employer. Accordingly, the ACT recommends that the IRS issue further guidance to Sponsoring Organizations with respect to the following:

- What responsibility, if any, does a Sponsoring Organization have to determine whether an Adopting Employer has timely amended a PAP when necessary?
- What responsibilities or actions, if any, are required of the Sponsoring Organization where it reasonably believes that due to operational errors, the plan may no longer be qualified or where an Adopting Employer fails to timely amend a PAP (beyond notification of the availability of EPCRS)?
- What constitutes a “reasonable and diligent effort” to apprise Adopting Employers of required amendments and what information should be maintained by the Sponsoring Organization to demonstrate its compliance with this requirement?
- What actions may be required for a Sponsoring Organization to withdraw the availability of the use of its PAP for an Adopting Employer (presumably after notifying the Adopting Employer of a plan failure which remains uncured)?

Exhibit A

**SUMMARY OF BENEFITSLINK SURVEY (33 RESPONSES)**

	<b>Failures</b>					<b>Totals</b>	<b>Less Likely</b>	<b>Just as Likely</b>	<b>More likely</b>
	1	2	3	4	5				
1	412(j) Plans exceeding 415					1		1	
2	Participation under 401(a)(26)					1		1	
3	ADP/ACP tests					20		14	6
4	Exclusions of part-time employees					2		2	
5	Independent contractors					2	1	1	
6	Seasonal employees/farming					1		1	
7	Eligibility failures					16		10	6
8	RMD failure					2	2		2
9	Definition of compensation					8	2 1 2	4	4
10	Controlled group failure					1			1
11	Non-amenders					18	3 1 1	7	8
12	Matching/compensation/true-ups					3	3	2	1
13	Excesses not timely distributed					2	1 1	1	1
14	Top-heavy minimum					6	1 1 1	3	2
15	Spousal consent					2	1 1	1	1
16	Participant loans					4	2 1 1	2	2
17	Checking the wrong box					7	2 1 2 1 1		7
	<b>Failures</b>					<b>Totals</b>	<b>Less Likely</b>	<b>Just as Likely</b>	<b>More likely</b>

Advisory Committee on Tax Exempt and Government Entities  
June 13, 2007



Exhibit B

**SUMMARY OF BENEFITSLINK SURVEY (110 RESPONSES)**

	Failures	1	2	3	4	5	Totals	Less Likely	Just as Likely	More likely
1	412(i) Plans exceeding 415								1	
2	Participation under 401(a)(26)								1	
3	ADP/ACP tests	2	0	2			4		2	2
4	Exclusions of part-time employees	2	1	1			4		3	1
5	Independent contractors									
6	Seasonal employees/farming									
7	Eligibility failures	23	13	7			43	3	26	9
8	RMD failure			4			4		2	
9	Definition of compensation	13	8	5			26	2	10	8
10	Controlled group failure	4	1	4			9		1	8
11	Non-amenders	7	9	3			19	3	5	10
12	Matching/compensation/true-ups	2	2	3			7		4	2
13	Excesses not timely distributed.									
14	Top-heavy minimum		2				2		2	
15	Spousal consent									
16	Participant loans		5	4			9		3	3
17	Checking the wrong box									

	Failures										Totals	Less Likely	Just as Likely	More likely		
	1	2	3	4	5											
18	Self-correction - EPCRS method not used															
19	5		2								7		1		6	
20	Ignoring multiple plan rules															
21	1										1		1			
22	415 excesses															
23		1	2		3								1		1	
24	Sign and date amendments															
25		1									1				2	
26		1	1								2				2	
27		2	1								3		3			
28	Excess deferrals															
29	Failing coverage															
30	1										1				1	
31	Plan asset rule															
32	9															
33	S Corp ESOPs															
34		1	2								3		1		2	

	Failures										Totals	Less Likely	Just as Likely	More likely
	1	2	3	4	5		Totals	Less Likely	Just as Likely	More likely				
35	Improper calculation of service	1	4	1			6		2	3				
36	Late 401k deposits	7	2	1			10		9					
37	Not following plan document	6	4	3			13		6	5				
38	Distribution errors	3	3	1			7		5					
39	414(h) plans		1				1	1						
40	401k deferral limit		1				1		1					
41	Improper effective dates			1			1			1				
42	Bad information from employer	1					1		1					
43	Failure to be clear about investment			1			1							
44	Failure to properly calculate contributions			1			1	1						
44	Failures in conjunction with mergers of entities and plans		1				1		1					



## EXHIBIT C

### PRE-APPROVED PLAN ACKNOWLEDGEMENT AND INFORMATION FORM *Required to Comply with Legal Requirements<sup>117</sup>*

**Who Must Complete:** Each Adopting Employer and Sponsoring Organization of a pre-approved plan<sup>118</sup> must complete all sections of this form and sign and date it below.

**Retention of this Form:** This form is to be retained by both the Adopting Employer and Sponsoring Organization. It is a required attachment to the Adoption Agreement (in the case of a Master or Prototype Plan and Volume Submitter Plan using an Adoption Agreement approach) or the plan document (in the case of a Volume Submitter Plan not using an Adoption Agreement). It must be available upon request of the Internal Revenue Service.

**Part I – To be Completed by Adopting Employer**

Name of Adopting Employer:	
Address of Adopting Employer:	
Employer Identification Number: (xx-xxxxxxx)	
Plan Number (3 digit):	
Employer Contact Name/Telephone No.:	
Receipt of Completed and Signed Adoption Agreement	<input type="checkbox"/> Yes; <input type="checkbox"/> No; <input type="checkbox"/> N/A (for VS single doc only)
Receipt of Plan and Trust Documents from Sponsor	<input type="checkbox"/> Yes

**Part II – To be Completed by Sponsor of Plan**

Type of Pre-Approved Plan	Other Features
<input type="checkbox"/> Master or Prototype Plan	<input type="checkbox"/> Standardized; <input type="checkbox"/> Non-Standardized
<input type="checkbox"/> Volume Submitter	<input type="checkbox"/> With Adoption Agreement <input type="checkbox"/> Without Adoption Agreement Authority to Amend on behalf of Adopting Employer <input type="checkbox"/> Yes; <input type="checkbox"/> No
IRS Publication No. [ ] – Provided to Adopting Employer and Document Preparer	Date Provided: _____
Subscription to IRS' <i>Retirement News for Employers</i>	_____ <i>Adopting Employer E-mail Address</i>

**Service Provider Information**

**Name, Address, Telephone, Fax**

Sponsoring Organization	
Third Party Administrator	
Record keeper	
Trustee of Plan Assets	

**Administrative Responsibility**

**Name, Address, Telephone, Fax**

Adoption Agreement/Plan Document Completion	
Preparation of Summary Plan Description	
Preparation of 5500s (put N/A if not required)	

I certify that the above information is true and correct to the best of my knowledge. I also certify that the Sponsoring Organization has explained my responsibilities as an Adopting Employer and that I am responsible for making certain that the administration of the plan is consistent with the terms of the plan and the Adoption Agreement.

<b>Name of Adopting Employer</b>	<b>Name of Sponsoring Organization</b>
<i>[signature]</i>	<i>[signature]</i>
<i>[Title]</i>	<i>[Title]</i>
<i>[Date]</i>	<i>[Date]</i>

<sup>117</sup> See IRS Rev. Proc. [ ]

<sup>118</sup> A pre-approved plan includes all Master and Prototype (Standardized and Non-Standardized and Volume Submitter Plans)



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

**A PROTOTYPE FOR PUBLIC SECTOR DEFINED  
CONTRIBUTION PLANS**

**Julian Regan and Susan Diehl, Project Leaders**

**June 13, 2007**

This page intentionally left blank

## **A Prototype for Public Sector Defined Contribution Plans**

Introduction to Project to be conducted from April 2007 – June 2008

### **Executive Summary**

As a joint production of the Employee Plans (EP) and Government Entities (GE) groups, the IRS ACT is undertaking a project aimed at identifying cost-effective ideas for further improving governmental 401(a) defined contribution plans operational and plan document compliance with IRS requirements. The ACT will deliver this project over a twelve month period with a final delivery date of June 2008 in two installments as follows:

#### **I. Outline Project, Justification and Preliminary Findings – June 2007**

On June 13, 2007 the ACT will document justification for the project by presenting anecdotal evidence of governmental 401(a) compliance challenges along with preliminary findings and a narrative project plan. Preliminary findings presently available are derived from stakeholder outreach the ACT began in April 2007 with the distribution of a compliance survey through two industry organizations, Benefits Link and the National Association of Government Defined Contribution Administrators (NAGDCA).

#### **II. Deliver Specific Recommendations to the IRS – June 2008**

The ACT will deliver recommendations for improving governmental 401(a) qualified plan compliance at the June 2008 meeting of the ACT. These recommendations, while not known at this time, may include the following:

- Recommend that the IRS establish a prototype system for governmental 401(a) plans similar to the system currently available to corporate 401(k) plans. This potential recommendation may include LRMs or proposed standard language for a prototype plan.
- Recommend educational content tailored to the needs of governmental 401(a) plan practitioners and sponsors. This information could be included in or at least referenced within the Federal, State and Local Governments (FSLG) Toolkit that is included in the FSLG section of the Government Entities (GE) Web site.

## **Background on Governmental 401(a) Defined Contribution Plans**

Governmental 401(a) defined contribution plans may be offered by government entities including states or any subdivision agencies or instrumentalities thereof. These plans are often, though not always, offered as supplements to existing defined benefit plans.

Although large employers typically have access to the resources needed to develop a fully compliant plan document, smaller employers with limited resources are not as well positioned to meet IRS plan document and operational requirements.

## **Justification for Project**

The IRS prototype system available to corporate 401(k) plans is not designed for government 401(a) plan sponsors because the requirements for these plans differ in a number of areas (e.g. Non-Discrimination Testing). Based on anecdotal evidence, the absence of a prototype-like system may result in some employers adopting suboptimal documents which may have been developed by practitioners using out of date, non-compliant language. Considering the IRS's stepped-up focus on enforcement, it is more critical than ever that government employers be positioned to operate compliant plans. Further, provided they are effective, any undertakings to improve governmental 401(a) plan compliance will advance the goal of encouraging employers who are not doing so now to provide a 401(a) benefit to their employees.

According to industry professionals, one potential vehicle for improving governmental 401(a) compliance, the prototype system, could benefit employers in a number of ways. The benefits include the following:

- Provide employers with a standardized agreement for which IRS approval may not be needed
- Provide for a lower cost of adoption
- Minimize the need for employer-initiated amendments when tax laws change

## **Project Methodology**

The ACT will obtain evidence that either supports or does not support the need for a governmental 401(a) prototype system and/or support the development of educational resources through the following means:

### I. Surveys of Employers and Practitioners

- Benefits Link – Commenced in April 2007
- NAGDCA – Commenced in March 2007
- Potential Additional Groups between June 2007 – April 2008

### II. Direct Outreach to Stakeholder Groups (actual and potential contacts)

- Government Finance Officers Association (GFOA)
- National Association of State Retirement Administrators (NASRA)
- National Association of Government Defined Contribution Plan Administrators (NAGDCA)

### III. Other Means of Data Aggregation

- Research sources to be determined

## **Preliminary Findings**

Findings based on surveys, direct outreach and data aggregation will be formally developed over the next nine to twelve months. However, early findings from both anecdotes and the Benefits Link survey include the following reported compliance challenges among 401(a) governmental defined contribution plans:

- Plans' failure to cover all eligible employees
- Documents never amended after adoption, especially when specimen plan used
- Documents incorrectly amended

## **Next Steps**

As mentioned previously, pending the findings of stakeholder outreach and data aggregation, the ACT will recommend potential alternatives which may include the development of a prototype system for governmental 401(a) plans similar and the development of cost-effective educational resources tailored to governmental 401(a) practitioners and plan sponsors. It is possible that this project will result in additional recommendations aimed at facilitating improved compliance for public sector plan sponsors and practitioners. Recommendations will go beyond concepts to include specific prototype and educational design enhancements.

As the project proceeds through the remainder of 2007 and into 2008, this group will apprise the ACT and the IRS TE/GE management team of findings, alternatives and developing recommendations through updates at ACT meetings.

The process outlined herein should result in a fully vetted set of practical recommendations that will deliver long-term benefits to one of the IRS's key stakeholder groups.

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

**PUBLIC EMPLOYERS' WITHHOLDING AND REPORTING  
FOR NON-RESIDENT ALIEN TAXATION**

**Steven W. Hoffman and Nicholas C. Merrill, Jr., Project  
Leaders**

**June 13, 2007**

This page intentionally left blank

**TABLE OF CONTENTS**

I. EXECUTIVE SUMMARY ..... 5

II. INTRODUCTION ..... 6

III. BACKGROUND ..... 7

IV. SCOPE OF THE PROBLEM ..... 9

V. RECOMMENDATIONS ..... 10

VI. METHODOLOGY ..... 12

VII. APPENDIX (TOOLKIT & “WHERE TO FIND IT”) ..... 13

This page intentionally left blank

I.

**EXECUTIVE SUMMARY**

The US Census Bureau reported in March 2002 that there were 87,525 state and local government employers, employing 18,349,000 workers, with payrolls amounting to 525,235 million dollars. It has been estimated that 20% of the American workforce is now employed by federal, state, or local governmental entities.

As has been noted in prior Internal Revenue Service (IRS) Advisory Committee on Tax Exempt and Government Entities (ACT) reports, public employers have long promoted voluntary compliance as the key to effective and efficient tax administration. Voluntary compliance by public employers requires not only executing specific withholding and reporting functions, but also includes identifying and eliminating barriers which prevent voluntary compliance.

The purpose of this project is to educate and enable public employers to fully comply with the unique requirements of withholding and reporting for the non-resident alien working in the United States. In addition, the project will focus on compliance with existing tax code requirements

The payroll preparation process for government employers has become increasingly more complex as new reporting and withholding requirements are legislated into the federal Internal Revenue Code (IRC), and state tax laws. The IRS Tax Exempt and Government Entities Division and its Federal, State and Local Governments (FSLG) component have previously acknowledged that public entity employers confront a unique set of payroll issues, as well as having to deal with those withholding and reporting problems faced by their private sector counterparts. The complexities of proper payroll preparation for public employers are increasing and will not go away.

**Recommendations**

The ACT's recommendations are intended to be a practical and cost-effective approach to assisting governmental employers in the preparation of their payrolls using the various resources available to the IRS. Accordingly this ACT's report suggest the IRS should:

1. Enhance the "Toolkit" on its website to assist Governmental Payroll Officers in determining the correct amount of withholding and the reporting requirements for non-resident aliens.
2. Increase contact with the public sector employment community through informational seminars and targeted mailings.

II.  
**INTRODUCTION**

The Bureau of the Census has estimated that there were approximately 88,000 units of government in the United States in 2002. It has also been estimated that currently as many as one out of five (20%) employees in the United States works for a federal, state, or local unit of government.

Payroll preparation and the timely completion of various monthly, quarterly, and annual reporting documents are an integral part of the employment process. These reporting documents are required at the federal, state, and/or local level and can be quite complicated to prepare correctly. This project will focus, however, on the federal payroll reporting requirements under the Internal Revenue Code (IRC). The responsibility of overseeing compliance with these reporting requirements rests with the IRS. The IRS publishes forms and publications that are generally applicable to all employers, including both the private and public sectors. There are, however, situations which require unique withholding and reporting requirements involving governmental employers. Successfully identifying and dealing with these unique withholding and reporting differences for public sector employers form the basis of the recommendations included in this project.

One area where such withholding and reporting differences have been an issue involves the proper withholding and reporting of tax for non-resident aliens. Due to these potential withholding and reporting differences, the proper completion of state and local government payrolls can be a difficult and confusing task. Turnover among payroll officers and a lack of training regarding these withholding and reporting differences may exacerbate the issue and increase the instances of errors.

In addition to causing errors that could adversely impact employees, these difficulties can also lead to an increase in the examination cycle time for the IRS during the compliance check or audit of a particular governmental entity. "Examination cycle time" is the length of time spent, measured in days, by the IRS when performing payroll compliance checks or audits. The accurate completion of payroll records should reduce the IRS examination cycle time for this specific task.

III.  
**BACKGROUND**

Non-Resident Alien Withholding and Reporting- State and Local Government Employees

IRC Section 1441 imposes a requirement upon a withholding agent to withhold federal income tax from non resident aliens, and to report those withholdings to the IRS for all payments made to or on the behalf of a non-resident alien.

These payments must be reviewed to determine the U.S. tax residency status of the payee or beneficiary of the payment before the payment is made.

For tax purposes there are four categories of tax residency status:

- U.S. Citizen
- Permanent Resident Alien
- Resident Alien for Tax Purposes
- Non-resident Alien for U.S. Tax Purposes

All payments made to or on behalf of a non-resident alien are generally subject to income tax withholding unless specifically exempted, either by U.S. tax law or an income tax treaty. All payments made to or on behalf of a non-resident alien generally are required to be reported to the IRS, regardless of whether the payment is taxable. This reporting is generally accomplished using IRS Form 1042-S and/or IRS Form W-2.

Examples of payments made to non-resident aliens include, but are not limited to:

- |                                      |                           |
|--------------------------------------|---------------------------|
| Compensation                         | Salary/Wages              |
| Non-Service Scholarships/Fellowships | Living Allowances         |
| Stipends                             | Awards                    |
| Independent Contractor Expenses      | Consultant Payments       |
| Certain Travel Expenses              | Honoraria                 |
| Royalties                            | Interest                  |
| Dividends                            | Certain Gambling Winnings |

Note: Payments do not have to be paid in cash or made directly to the individual to be considered income. Payments made to a third party on behalf of the individual are also subject to the withholding and reporting rules for non-resident aliens.

The United States has Tax Treaties with approximately 64 countries, each of which contains specific requirements for exemption. If a non-resident alien wishes to claim an exemption from U.S. income tax withholding because of an income tax treaty, the individual must file one or both of the following two forms to claim the exemption

- IRS Form W-8BEN (non-service scholarship/fellowship, stipend and royalty payments)
- IRS Form 8283 (consultant, honoraria, independent contractor and employee payments)

## Public Employers' Withholding and Reporting for Non-Resident Alien Taxation

The amount of U.S. income tax withholding depends on the type of payment.

Non-resident alien employees may only complete IRS Form W-4 as "Single" (regardless of marital status), one withholding allowance, plus the additional amount added to the taxable base prior to graduated withholding calculation. An employee may be exempt from FICA tax withholding – regardless of the employer – if they are (i) a non-resident alien, (ii) present in the U.S. under and F-1, J-1, M-1 or Q-1 immigration status, and (iii) performing services in accordance with the primary purpose of the visa's issuance (i.e., the primary holder of the immigration status, the "-1".)

IRS Form 1042-S is the annual tax statement used to report most payments and tax withholding to non-resident aliens. The form must be issued by the Withholding Agent to both the IRS and the non-resident alien no later than March 15.

If the individual receives taxable wages, he or she may receive both IRS Form 1042-S and IRS Form W-2; however, a non-resident alien should never receive a Form 1099.

All non-resident aliens must have a U.S. issued taxpayer identification number (e.g., a social security number or Individual Taxpayer Identification Number ("ITIN")). If the non-resident alien does not have a SSN, he or she must apply for an ITIN using IRS Form W-7.

If the withholding agent does not collect the SSN or ITIN from the non-resident alien, a \$50 reporting penalty is applied per form.

Tax withheld from non-resident aliens (excluding graduated withholding for employee compensation) must be submitted under a separate deposit and associated with IRS Form 1042; the tax deposit schedule is different for IRS Forms 1042 than for IRS Forms 941 or IRS Form 945.

IV.

**SCOPE OF THE PROBLEM**

**Unique Taxation and Reporting Requirements for Non-Resident Aliens**

There are several possible variations to the taxation, withholding and reporting requirements for non-resident aliens. These variations depend upon the circumstances of their employment. It is possible that a non-resident alien employee could properly appear on the payroll in any one of the following withholding and reporting scenarios depending upon the employees visa status, length of stay in the United States, prior visits to the United States, etc. This employee could be subject to taxation at the various levels of:

- a) Compensation paid to employees at graduated withholding with restricted rates plus the additional amount required under IRS Notice 2005-76;
- b) Consultant/honoraria/independent contractor payments subject to 30% withholding;
- c) Scholarship/fellowship/grant/stipend payments (non-service) subject to 14% withholding; or
- d) Dividends/Interest/Royalties/Gambling, etc. subject to various withholding rates.

There have been instances noted by the IRS during either a compliance examination or audit when employees have been miscoded on the payroll, and therefore, misreported to both the IRS and SSA. Previous reports of the Advisory Committee on Tax Exempt and Government Entities (ACT) have touched on this issue. TE/GE Education and Outreach (see June 21, 2002 ACT report), Gateway Opportunities: FSLG and Its Customers (see May 21, 2003 ACT report), and Barriers to Voluntary Compliance: Governmental Employers' Perspective (see June 9, 2004 ACT report), have all attempted to address one facet of the problem or another. As a result of the recent transition from education to compliance by the IRS, however it appears that withholding and reporting errors remain an issue that needs further clarification and training.

**Payroll Compliance Errors**

Payroll compliance errors can be a serious issue for public employees. More than 30% of electronically filed IRS Forms 1042-S and transmittal IRS Forms

1042-T contain incorrect or erroneous information resulting in processing delays according to the IRS.

The IRS indicates the number of 1042S forms filed with IRS in 2004 to be approximately:

2.7 million and in 2005 there were approximately 2.6 million 1042S forms filed.

Thus, in 2005, approximately 780,000 electronically filed 1042-S forms contained errors.

Further the number of Forms 1042 filed in 2005 were approximately 31,000.

According to the IRS, during the first several years of its existence, the FSLG group was primarily focused on outreach and education of governmental customers. This focus has changed recently as the IRS has shifted its focus from that of education and outreach, to compliance. The IRS Federal, State and Local Governments Work Plan, dated October 1, 2006, includes the goals of expanding the compliance enforcement activity, understanding and improving compliance, and meeting customers needs to reach those goals. In FY2004, outreach activities were reduced from 60% of available resources to 25%, and compliance activities increased from 40% to 75% of available resources. In FY2005, this ratio increased for compliance activities to 80% and in FY2006, is expected to grow to 85% of available resources. Outreach efforts are expected to decline from 70% in FY2005, and to 15% in FY2006.

## V.

### **RECOMMENDATIONS**

The goals of: a) more accurate and timely processing of an entity's payroll; and b) increased compliance with the federal tax code, will have a direct benefit to the IRS. The goal of more accurate and timely payroll processing will provide for better reporting of non-resident alien's tax information to the IRS.

The goal of increased payroll compliance should translate into more effective and efficient compliance checks and audits by the FSLG staff and management. The recommendations in this report are for increasing compliance in certain major areas, each of which can have a measurable and useful benchmark.

#### Payroll Officer "Toolkit"/Alternative sources of information.

The ACT recommends that FSLG enhance the "Toolkit" on its website which would be a valuable resource for new and existing payroll officers. This

enhancement to the "Toolkit" would provide a single location on the IRS website for governmental employers to visit, which would provide assistance to a number of routine, as well as complex, tax withholding and reporting issues for non-resident aliens. The benefits to be derived from this website would be a much more focused, comprehensive, and easier to use information-gathering area for the users involved in the preparation of government payrolls.

The enhancement of the "Toolkit" is not considered to be the final step in the compliance process, nor is it perceived to be the solution to all payroll withholding and reporting problems for non-resident aliens. It should, however, be considered as a significant step forward in addressing the accurate resource and educational needs of the public employer community as a whole. An explanation of what is included in this "Toolkit" is attached in the Appendix, as well as a reference guide for where to find the various government publications mentioned in this report. Specifically, it is recommended that the IRS:

Include the Form 1042-S and Form 1042 in the "Topical Index" search feature on its website. When searching for the Form 1042-S utilizing the proper name of Form 1042S, "Foreign Persons US Source Income Subject to Withholding," there is no result on the IRS website using the Topical Index when searching on the letter 'F'. Also, while there are many forms associated with non-resident alien taxation when searching the Topical Index with the letter "N", for non-resident alien, the Form 1042-S and Form 1042 are not displayed in the result.

Include Forms 1042-S and 1042 as forms listed within the existing FSLG Toolkit as a possible tax form for use by governmental entities. Many state universities are governmental entities and employ large numbers of non-resident aliens.

Include in the Federal, State and Local Governments' FAQ's website an FAQ topic for Employment Taxes – Withholding and Reporting – for Non-Resident Aliens

Revise Form 7018, Employer's Order Blank, contained within Publication 393, Federal Employment Tax Forms, to include Forms 1042-S and 1042.

Prepare a survey document for federal, state, and local government employers to derive the extent of compliance with the requirements of withholding and reporting for non-resident aliens and analyze results. This could be accomplished in the same manner as prior surveys that have been conducted by the IRS – determine the customer base of 1042-S filers, identify a random sample, prepare a survey document, distribute them and analyze the results for future actions.

Increased contact with the public employer community through informational seminars. Many large public employers have the resources and knowledge base to identify a specific payroll problem and address it properly before the employee is paid, or to correct a situation shortly after it has occurred. This is not always the case, but generally is true. The dilemma is how to administer education and news updates to the smaller public employers who may not have as much institutional knowledge of these issues. Arranging for informational seminars with targeted mailings to a specific audience would assist in getting the message out to this particular stakeholder group.

## VI.

### METHODOLOGY

- Issues related to State and Local Government payroll withholding and reporting for non-resident alien taxation were identified, in part, through anecdotal customer feed back provided through the University Tax Peer Group. (Steven W. Hoffman, ACT Committee, is a member of this group)
- Issues related to IRS Tax Exempt/Government Entities (TE/GE) examinations and compliance checks of State and Local employers were identified in part through discussion with TE/GE Senior Staff and through customer feedback.
- Recommendations were based in part on the TE/GE Concept of Operation for FY2006 which identified, among other objectives, a goal to improve the quality of customer contacts, particularly in light of an incremental reallocation of resources from outreach to enforcement activities.
- Data included in this report was derived from the FY2007 FSLG Work Plan.
- Methodology included ACT members' examination of employer educational resources inclusive of the Federal, State and Local Governments (FSLG) section of the IRS website for state and local government employers.
- IRS senior staff provided ACT FSLG members with drafts of the Government Entity "Toolkit" on or about January 2006.
- In the future, additional methods to assess the benefits of the "Toolkit" may include a future survey(s) of customer groups, including NACUBO (National Association of College and University Business Officers) members.

VII.

**APPENDIX**

**Government Entity Toolkit**

This Toolkit consists of two parts: (a) Public Employer's Toolkit which provides information to government entities and payroll officers working for government entities in meeting their Federal employment tax obligations and (b) Compliance Toolkit which provides information to help government entities and their powers of attorney understand the enforcement process.

**Public Employer's Toolkit**

If you are a new employer, or new to dealing with federal employment tax, the first place to go for information is IRS [Publication 15](#), Employer's Tax Guide (Circular E). This publication is revised each year and contains the basic information employers need to be able to collect adequate information so they can determine and pay their and their employees' portion of employment tax liability, file correct tax returns, and withhold Federal taxes, where necessary.

You may also want to consult the following Publications that include information specific to government entities:

[Public Employer's Tax Guide](#)

[Publication 963](#), Federal-State Reference Guide

[Publication 15-A](#), Employer's Supplemental Tax Guide

[Publication 15-B](#), Employer's Guide to Fringe Benefits

The following list includes most federal tax forms and instructions you are likely to need to process payroll and file necessary returns with the IRS. You can download the forms and instructions from the links.

Note: some of the forms are information copies only and cannot be used for filing. A list of all IRS forms (in fillable format) and publications is available at <http://www.irs.gov/>.

- [Form SS-4](#), *Application for Employer Identification Number* ([with instructions](#)).
- [Form W-2](#), *Wage and Tax Statement* ([with instructions](#)). This form must be issued to recipients of wages and filed with the IRS.
- [Form W-3](#), *Transmittal of Wage and Tax Statements*. This form is used to transmit the Form W-2 to the IRS.
- [Form W-4](#), *Employee's Withholding Allowance Certificate*. This form must be furnished to each employee upon hiring to determine their correct withholding. The employee may submit new certificate at any time.

## Public Employers' Withholding and Reporting for Non-Resident Alien Taxation

- [Form W-9, Request for Taxpayer Identification Number and Certification \(with instructions\)](#). This form must be furnished to each person who receives a payment from a government entity in order to verify the recipient's taxpayer identification number. Examples of such payments are interest payments made by a government entity and payments made to persons who are not employees of the government entity.
- [Form 941, Employer's Quarterly Federal Tax Return \(with instructions\)](#). This form must be filed each quarter by an employer, including a government entity, who pays wages during a calendar quarter.
- [Form 945, Annual Income Tax Withholding Return \(with instructions\)](#). This form must be filed by each employer, including a government entity, to report withholding (including back up withholding) on payments other than wages. Examples of such payments made by a government entity are pensions, annuities, and IRAs.
- [Form 1099-MISC, Miscellaneous Income \(with instructions\)](#). This form must be filed by any payer, including a government entity, who makes certain payments for services to recipients who are not employees.
- [Form 1096, Annual Summary and Transmittal of U.S. Information Returns](#). This form is used to transmit Form 1099-MISC to the IRS.

You may be required to provide the following non-tax forms to new employees. They are available from other Federal agencies:

- [Form I-9](#), <http://uscis.gov/graphics/formsfee/forms/i-9.htm> *Employment Eligibility Verification*. This form can be obtained from the U.S. Citizenship and Immigration Services.
- [Form SSA-1945, Statement Concerning Your Employment in a Job Not Covered by Social Security](#). This form can be obtained from the Social Security Administration.

For further on-line information about employer responsibilities, visit the web page for [Employment Taxes for Businesses](#).

### **Government Entity Compliance Toolkit**

The following information explains what a government entity can expect during a compliance check or an examination conducted by FSLG. It also provides information with regard to adequate record keeping by government entities, disclosure constraints on the IRS and consent by government entities authorizing the IRS to disclose tax information to third parties.

- ***FSLG Compliance Program: Compliance Checks, Examinations, and the Difference Between Them*** – The purpose of a compliance check and an examination, and the difference between the two
- ***What Occurs During a Compliance Check*** – What a government entity can expect during a compliance check, including the types of questions asked during a compliance check, the kinds of information requested, and possible outcomes of a compliance check. This also includes sample compliance check opening and closing letters, proforma information document requests, etc.
- ***What Occurs During an Examination*** – What a government entity can expect during an examination, including the types of questions asked during an examination, the kinds of information requested, and possible outcomes of an examination. This also includes sample examination opening and closing letters, proforma information document requests, etc.

## Public Employers' Withholding and Reporting for Non-Resident Alien Taxation

- **Basic Recordkeeping for Employment Taxes and Information Return Reporting** – Suggestions about methods for maintaining employment tax records and vendor information. This also details what records must be maintained by a government entity with respect to an employment tax exam.
- **Disclosure Restrictions** – Constraints on the IRS with regard to disclosure of tax information of a government entity to third parties. This also provides consent for disclosure to the IRS, including power of attorney provisions, third party contact procedures, etc.
- **Appeals Process** – Information about the IRS Appeals Office and procedure for requesting review by the Office of Appeals in case of an adverse determination made by FSLG after an examination.

<b>Where To Find It</b>	
<i>Consult the publications cited as primary sources for each topic.</i>	
<b>For information on...</b>	<b>See...</b>
Deposit rules	<a href="#">Publication 15</a> (Circular E)
Who is an employee?	<a href="#">Publication 15</a> (Circular E)
Withholding	<a href="#">Publication 15</a> (Circular E)
Information reporting	<a href="#">General Instructions for Forms 1099, 1098, 5498, and W-2G</a>
Filing requirements	<a href="#">Publication 15</a> (Circular E)
Characteristics of government entities	<a href="#">Publication 963, Federal-State Reference Guide</a>
Section 218 social security coverage	<a href="#">Public Employer's Tax Guide</a> <a href="#">Publication 963, Federal-State Reference Guide</a>
Public retirement systems (social security replacement plans)	<a href="#">Publication 963, Federal-State Reference Guide</a>
Nonqualified (section 457) retirement plans	<a href="#">Public Employer's Tax Guide</a> <a href="#">Publication 963, Federal-State Reference Guide</a> (includes Notice 2003-20)
Fee-based employees	<a href="#">Publication 963, Federal-State Reference Guide</a>
Medicare coverage	<a href="#">Publication 963, Federal-State Reference Guide</a>
Cafeteria plans	<a href="#">Publication 15-B</a> Employer's Guide to Fringe Benefits
Sick pay	<a href="#">Publication 15-A, Employer's Supplemental Tax Guide</a>
Employee meals and lodging expenses	<a href="#">FSLG Taxable Fringe Benefits Guide</a> <a href="#">Publication 463, Travel, Entertainment, Gift and Car Expenses</a>
Employee use of employer vehicle	<a href="#">Publication 15-B</a> Employer's Guide to Fringe Benefits <a href="#">FSLG Taxable Fringe Benefits Guide</a>
Wages and items included in compensation	<a href="#">Publication 15-B</a> Employer's Guide to Fringe Benefits <a href="#">FSLG Taxable Fringe Benefits Guide</a>

## Public Employers' Withholding and Reporting for Non-Resident Alien Taxation

Clothing and uniform allowances	<a href="#">Publication 15-B</a> Employer's Guide to Fringe Benefits <a href="#">FSLG Taxable Fringe Benefits Guide</a>
Bonuses and supplemental pay	<a href="#">Publication 15</a> (Circular E)
Emergency workers	<a href="#">Publication 963</a> , Federal-State Reference Guide
Volunteers	<a href="#">Publication 963</a> , Federal-State Reference Guide
Accountable plans	<a href="#">Publication 15</a> (Circular E)

