Advisory Committee on Tax Exempt and Government Entities (ACT)

Report of Recommendations

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Public Meeting
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Advisory Committee on Tax Exempt and Government Entities (ACT)
Public Meeting
1111 Constitution Ave, NW
Room 3313
Washington, DC 20220
June 9, 2004

AGENDA

8:30 – 9:00	Meet and Greet
9:00 – 9:30	Welcome and Opening Remarks • Mark W. Everson, Commissioner of Internal Revenue • Steven T. Miller, TE/GE Commissioner • Steven J. Pyrek, Designated Federal Official of the ACT
9:30 – 9:45	ACT Overview Report • Donald J. Segal, Chairman of the Advisory Committee on Tax Exempt and Government Entities
9:45 – 10:15	*Barriers to Voluntary Compliance: Governmental Employers' Perspective* Don Waugh, Project Leader
10:15 – 10:30	BREAK
10:30 – 11:00	*Indian Tribal Government Guidance Priorities* Raymond C. Etcitty, Jr., Project Leader
11:00 – 11:30	*Employee Plans Operational Guidance* Brian L. Anderson, Project Leader
11:30 – 12:15	*Audit Cycle Time and Communications: Employee Plans and Tax Exempt Bonds* John W. Schroeder, Project Leader
12:15 – 12:30	BREAK
12:30 – 1:15	*Reviewing IRS Policies and Procedures to Leverage Enforcement*: *Recommendations to Enhance Exempt Organization's (EO's) Enforcement and Compliance Efforts* Karl E. Emerson, Project Leader
1:15 – 1:30	Closeout

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

In the two years since the Advisory Committee on Tax Exempt and Government Entities (ACT) first met in public session to make its recommendations to the Internal Revenue Service, both the ACT and the Service have made much progress. The ACT members believe that the relationship between the ACT and the Service's Tax Exempt and Government Entities Division (TE/GE) continues to foster a deeper and broader understanding of the issues faced by the Internal Revenue Service and the customers it serves. This mutual understanding benefits the public, because the ACT provides an experienced external perspective on TE/GE's tax administration policies and procedures. Also, it benefits the Service because at a time of tight resources, the IRS can make better-informed decisions about modifying and enhancing its programs based on customer feedback.

The customers of TE/GE include employee retirement plans; charities and other tax-exempt organizations; tax-exempt bond issuers; federal, state, local and Indian tribal government bodies, and the professionals who deal with these entities. Each of these groups has a special relationship with the IRS. They generally are not subject to tax, but must comply with specialized and highly complex provisions of tax law.

Because of the specialized nature of its mission to serve this unique customer base, TE/GE has been able to develop new outreach and education programs, as well as products and services to enhance voluntary compliance through increased awareness. As was the case in our previous reports of recommendations, the reports we offer today include recommendations on TE/GE's outreach, audit, and compliance programs.

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

Barriers to Voluntary Compliance: Governmental Employers' Perspective

Issue

Voluntary compliance by public employers requires not only executing specific withholding and reporting functions, but also identifying and eliminating barriers, which prevent voluntary compliance. The creation pf the Federal, State and Local Governments Division within TE/GE shows the Department of the Treasury and the IRS recognize that "governmental employers" represent a special and diverse community.

The ACT team approached this project on barriers to voluntary compliance through a variety of informational gathering methods and direct interviews with affected entities comprising the primary public sector employer and IRS interfaces. The underlying review was tied to a single concept – what, if any, opportunities exist for FSLG and

other IRS/Treasury entities to advance voluntary public sector employer compliance as expressed by state and local government employers?

Recommendations

The recommendations in this report are presented in three major areas, each of which addresses a central opportunity as well as specific recommendations embracing barrier removal concepts. We realize that FSLG could not accomplish all the recommendation on its own, but we believe FSLG should serve as an advocate to the IRS and other Treasury entities when FSLG becomes aware of fundamental customer needs that are not being met.

Partner with the public employer community. We believe FSLG can implement these recommendations independently. The emphasis in this section of the report is on partnering with stakeholders and coordinating with the other IRS divisions issues that affect FSLG stakeholders.

Dismantle compliance barriers through identification of barriers. In this section of the report, we identify recommendations that we realize FSLG cannot achieve on its own. However, these recommendations involve items that are critical for state and local governments to be able to timely comply with their responsibilities as employers. FSLG should become actively engaged in intra-Service discussions about these items to ensure state and local government concerns are considered.

Make the concept of voluntary compliance through barrier elimination a strategic focus for customer services and regulatory actions. This section makes two recommendations that FSLG and the Service should advance in order to make barrier removal a strategic focus for advancing voluntary compliance and customer services.

Indian Tribal Advice and Guidance Policy

Issue

A major obstacle to the ability of tribal governments to implement long-term self-sustaining economic development projects are the many restrictions within the Indian Tribal Governmental Tax Status Act of 1982 (25 U.S.C. §7871(e)). This Act contains limiting provisions that prohibit tribal governments from issuing tax-exempt bonds except for the performance of "essential governmental functions." The federal government's failure to understand and accommodate the developmental status of many tribal economies in defining "essential governmental function" actually defeats many tribes' ability to operate as a fully functioning governmental entity on an equal footing with state and local governments. The Act discourages the development and acquisition of the most basic elements of infrastructure taken for granted off the reservation, but so lacking and desperately needed by many tribal communities in virtually every state of the Union.

Recommendations

The IRS should take steps to develop guidance and instruction to tribal governments for the term "essential governmental function:

- The IRS should request the Treasury Department to develop regulations to define "essential governmental function" under §7871(e).
- The IRS should clarify that the "essential governmental function" under §7871(e) be construed in accordance with the term "essential governmental function" under §115.
- The IRS should withdraw Field Service Advice 200247012 and suspend issuance of any other non-precedential guidance.

Employee Plans Operational Guidance for Small Employers

Issue

Employer maintenance of a retirement plan has two general aspects: the plan document and plan operation. The plan document is often the easier of the two; an employer generally has no trouble obtaining a properly written document from a retirement-plan provider, typically the financial institution that holds the retirement-plan funds. Operation of the plan in compliance with the plan document and with applicable law is where most employers have trouble. Plans with employee salary deferrals, such as 401(k) plans and 403(b) tax-sheltered annuity programs, seem to have an especially-high incidence of plan-operation problems.

Overall, an abundance of guidance is available to help employers operate their plans properly. Unfortunately, however, much of the currently available plan-operation guidance is not very useful to the typical small employer. Much of the guidance is written for professionals or people who understand retirement-plan fundamentals. Many small employers simply do not understand the guidance, and will not take the time to understand it. As a result, we see a crucial need for very basic, easy-to-understand guidance for employers. A key component of such guidance would be checklists, because checklists are often better than standard narrative text at focusing a reader's attention on what needs to be done.

Recommendations

Over the years, the Internal Revenue Service TE/GE Division has provided much guidance to employers regarding the proper operation of their retirement plans. We recommend that TE/GE provide even more such guidance, especially basic information, such as checklists, useful to small employers.

We also recommend that TE/GE publish comprehensive resource guides, in plain English, on the TE/GE website, for the most common plans involving salary deferrals:

401(k) plans and governmental 403(b) tax-sheltered annuity programs. The guides, and their component checklists, are intended to educate employers regarding best practices, common mistakes, and general responsibilities, so that employers can better operate their plans in compliance with the plan documents and applicable law.

We further recommend that, if the resource guides are well received by employers, TE/GE provide similar guides for plan participants, so that participants can more easily monitor whether the plans are being properly operated.

Finally, we recommend that TE/GE periodically ask the employee-plans members of ACT to provide input on plan-operational guidance that is under development by TE/GE.

Audit Cycle Time and Communications: Employee Plans and Tax Exempt Bonds

Issue

Two years ago the ACT undertook a report on TE/GE audit programs to explore methods to make the audit program more effective and as painless as possible to filers. Recently, TE/GE itself undertook a program related to exam reengineering (now christened the "Filing to Closure Examination Redesign Team").

We believe an effective audit program serves several purposes, including:

- Visible enforcement – to encourage self-compliance by others.
- Correction – to ensure that past improper practices are corrected retroactively.
- Compliance – to ensure that the taxpayer operates in compliance going forward and that current rules can be complied with (demonstrate that the rules work).
- Data gathering for education – to collect information to shape audit process and self-corrections processes.
- Identification of abusive transactions – to identify and examine potentially abusive transactions in a timely fashion.

Self-compliance is the cornerstone of U.S. tax compliance. An effective audit program can encourage higher compliance by ensuring that non-compliers are targeted for audit and that persons who are abusing the tax process experience heavy penalties relative to those who are merely negligent or who do not profit from their non-compliance. Accordingly, we believe that audit processes should be shaped to target abusive practices and be more tolerant of those who do not profit from their noncompliance.

Recommendations

Our recommendations are based on specific aspects of the audit process as it relates specifically to Tax Exempt Bonds and Employee Plans. In addition, we make recommendations that are common to both areas.

Communications with the taxpayer. Our recommendations in this area include:

- Establish Web-based audit process guides and other Web-based tools.
- Initiate audits through "soft contacts."
- Manage taxpayer expectations by setting expectations early and simply.
- Seek more cooperative approaches, and in particular to adopt a practice of entering into audit contracts of the type implemented by the Service's LMSB division.
- Provide ample advance notice of actions, such as IDRs, on-site visits, or actions requiring taxpayer response.
- Simplify closing letters and actively communicate general findings. In particular, we encourage TE/GE to actively communicate findings more quickly and reduce the delay between the final on-site visit or substantive communication and the final closing letter
- Prepare and communicate to taxpayers "top ten" lists of common audit problems, and "red flag" facts that suggest possible underlying problems.

Reducing Cycle Time. For the IRS, "cycle time" is the period between the date of an auditable event (such as filing of an informational return) and the date an audit is completed. From the taxpayer's point of view, the cycle time is measured from when the notice of audit is received to when the auditor is out the door and the letter of no action or other decision letter is received. Long cycle times generate taxpayer dissatisfaction and impede effective audits as memories become stale or documents become difficult to retrieve. Our recommendations in this area include:

- Employ techniques that focus examination selection on the most likely problem cases.
- Plan the audit prior to any contact with the taxpayer.
- Develop programs to expand the use of "focused" or "limited scope" audits.
- Continue to apply alternate audit approaches, and in particular to implement joint agreements with taxpayers in large cases.
- Match cases to agents based on expertise, not geography, and actively manage agent inventory.
- Devote significant resources to training examination agents.
- Actively manage cases and caseloads by establishing guidelines and norms for the amount of time a case should take, monitor agents' progress frequently, and consider use of on-line tools and administrative staff to monitor time lines.
- To the extent audit cycle time is improved by initiating audits early, self-correction procedures should be modified.

Other suggestions. We believe consistency is an important element of fairness in any examination program. For this reason, we recommend that TE/GE continue to devote resources to publishing "Audit Guidelines" for use by agents and plan sponsors. We also believe that on occasion the practices of third parties should be targeted in audit and compliance reviews, and remedies sought against those third parties. Many taxpayers rely on vendors to manage significant parts of their programs. We encourage TE/GE to train agents in use of enforcement tools such as Section 6700 (promoter penalties) or Section 6701 (aiding and abetting penalties), referrals to the IRS Office of Professional Responsibility, or referrals to Criminal Investigation (CI). We believe TE/GE should consider using these tools more broadly, looking at systemic errors and patterns of poor compliance, and consider expanding the scope of Circular 230

Reviewing IRS Policies and Procedures to Leverage Enforcement (RIPPLE): Recommendations to Enhance Exempt Organizations' Enforcement and Compliance Efforts

Issue

Over the past decade the number of exempt applications filed with the IRS's Exempt Organization Division (EO) has steadily increased each year and reached an all-time high of 91,439 in 2003. As a result, there are now over 1,640,949 exempt organizations and over 964,418 of these have been granted 501(c)(3) status as either public charities or private foundations. During this period, EO staffing levels have remained essentially static.

To deal with the ever-growing number of determination requests, examination personnel over the last several years have been reassigned to the determination process so that these requests for exempt status could be evaluated in a more timely manner. Partly because of this reassignment of personnel, EO's examination rate has, for some time now, fallen below 1 percent.

With such a low examination rate, it is widely believed that the current EO compliance presence is not sufficient to guarantee appropriate attentiveness by the exempt organization community or to engender confidence among contributors and others that credible oversight of the sector exists.

It is imperative that EO explore ways to enhance its enforcement and compliance efforts so that public confidence in both EO's effectiveness and in the exempt sector itself can be increased. State regulators and EO each play vital roles in maintaining confidence in the exempt sector. EO plays a particularly important role because it is the governmental entity responsible for ensuring that only qualified organizations are granted, and retain, exempt status.

Our recommendations are intended to help EO enhance its enforcement and compliance efforts by increasing its "presence" in the exempt organization community.

As EO implements each of our recommendations, there will be an ever-widening "ripple" effect throughout the exempt organization community as EO's enhanced enforcement and compliance efforts become more widely known. As each recommendation is implemented, both the reality and perception that EO is more effectively overseeing the sector will increase --- much like a single stone tossed into the water has an ever-widening or "ripple" effect on the water into which it is thrown.

Recommendations

Exam-Related: EO should improve its case selection efforts and develop an ongoing feedback process for continuous refinement of its selection criteria. In addition, EO should increase the number of "limited scope" audits and targeted "soft contacts" within the exempt organization community.

Publicity-Related: EO should improve publicity regarding its enforcement efforts and compliance concerns. In addition, EO should publicize widely the availability and advantages of electronic filing of Form 990 and encourage exempt organizations to utilize this option.

Staff-Related: The IRS should follow through with its commitment to hire 72 additional EO examination agents and should improve and enhance its current training and education programs for agents and examiners.

Public Education-Related: EO should increase its issuance of technical and precedential guidance and increase the number and technical content of its public presentations and other educational initiatives.

Consequence-Related: EO should increase the consequences for both individuals and organizations that intentionally submit false Form 990 returns or otherwise violate the law.

Enforcement-Related: EO should implement a formal voluntary compliance program and vigorously support amendment of Section 6103 of the Internal Revenue Code.

Conclusion

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

As Chairman of the ACT and on behalf of the Committee and the public whom we represent, I would like especially to thank the members of the ACT who are leaving the committee after this meeting.

- Brian L. Anderson, of Dewitt Ross & Stevens in Madison, WI
- Karl E. Emerson, of the Pennsylvania Bureau of Charitable Organizations in Harrisburg, PA
- Raymond C. Etcitty, Jr., of the Navajo Nation Legislative Council
- Perry Israel, of Orrick, Herrington & Sutcliffe in Sacramento, CA
- Sara E. Meléndez, of the George Washington University in Washington, DC
- Donald J. Segal, of the Segal Company in New York, NY
- Don Waugh, Assistant State Controller of the State of North Carolina

Each of you has made significant contributions to the work of the Committee and to the operations of the IRS.

ADVISORY COMMITTEE
ON TAX EXEMPT AND GOVERNMENT ENTITIES

Member Biographies

EMPLOYEE PLANS

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

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

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

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

- **Michael P. Coyne**, Westlake, OH

  Mr. Coyne is an attorney-at-law with Waldheger-Coyne. His practice focuses on tax, corporate and employee benefit issues of small employers and closely held businesses, with special emphasis on clients involved in health care. He presently represents approximately 250 qualified plans. He holds a Juris Doctor in Law from Case Western Reserve University School of Law.

- **Douglas Kant**, Boston, MA

  Mr. Kant is Senior Vice President and Deputy General Counsel at Fidelity Investments, where he works primarily with institutional retirement and employee benefits business units. He has a 25-year background in tax, ERISA and compliance aspects of qualified and non-qualified retirement plans of both for-profit and tax exempt sectors. He is on the Board of Directors of the American Benefits Council and holds a Juris Doctor in Law from the Boston University School of Law.

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

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

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

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

EXEMPT ORGANIZATIONS

- **Ann Western Bittman**, Washington, DC

  Ms. Bittman is Vice President, Finance & Administration and Chief Financial Officer of AF&PA and a member of the American Society of Association Executives (ASAE), where she has served in numerous leadership positions. She has over 13 years of experience in not-for-profit organizations and, because of her involvement in the association community, has had first-hand experience with many of the financial issues faced by tax-exempt organization. She is a Certified Public Accountant (CPA), a Certified Financial Planner (CFP) and a Certified Association Executive (CAE). She holds a Bachelors degree in Business Administration from Georgetown University.

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

  Ms. Bjorklund is a partner in the law firm of Simpson Thacher and Bartlett, LLP in New York, where her clients include educational organizations, tax-exempt health care organizations and private foundations involved in substantial domestic and international grant-making. She is a long-time active participant in the American Bar Association and is the past Chair of the ABA Tax Section - Exempt Organizations Committee. Ms. Bjorklund, a magna cum laude graduate of Princeton University, is a graduate of the

Columbia University School of Law and holds a Ph.D. in medieval studies from Yale University.

- **Deirdre Dessingue,** Washington, DC

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

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

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

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

  Dr. Meléndez is a Professor of Nonprofit Management at the George Washington University School of Public Management. She holds an Ed.D. from the Harvard Graduate School of Education, an MS in education from Long Island University and a BA in English from Brooklyn College, CUNY. Previously she was President of Independent Sector, a membership organization of more than 700 national nonprofit and philanthropic organizations headquartered in Washington, DC, when she became a member of the ACT in 2001.

- **George A. Vera**, Los Altos, CA

  Mr. Vera is a CPA and the Vice President and Chief Financial Officer of the Packard Foundation, one of the largest private foundations in the nation. He is responsible for the finance and administration functions of the foundation, including investments, finance and accounting, information technology, facilities and grants management. He holds a Masters of Business Administration from Harvard University.

GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS

- **David Barrow**, Sacramento, CA

  Mr. Barrow is the Manager of the Tax Support Section of the California State Controller's Office and has over 29 years of state and local government experience spanning employment tax, reporting and Social Security Section 218 coverage. He is a member of the National Conference of State Social Security Administrators (NCSSSA) and is recognized as one of the most experienced and informed state officials in the nation in the area of federal employment tax coverage, withholding and reporting.

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

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

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

- **Raymond C. Etcitty, Jr.,** Dallas, TX

  Mr. Etcitty is the Chief Legislative Counsel for the Navajo Nation, the largest Indian tribe in the United States, with a land base larger than West Virginia. He was formerly Executive Director of the Office of the Navajo Tax Commission, the tax and revenue department of the Navajo Nation. He has also taught courses in Federal Indian Law and Indian Taxation at the University of New Mexico School of Law and the University of Phoenix. Etcitty holds a Juris Doctor from the University of New Mexico School of Law.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

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

  Mr. Burke is a Partner with the public accounting firm of Ernst & Young LLP. Mr. Burke specializes in post-issuance arbitrage compliance for tax-exempt bonds. He is a Certified Public Account

and serves as advisor to the Government Finance Officers Association Debt and Fiscal Policy Committee.

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

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

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

I. Barriers to Voluntary Compliance:
Governmental Employers' Perspective

Don Waugh, Project Leader
David H. Barrow
Mary Beth Braitman - Adjunct

June 9, 2004

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Executive Summary

Although the public sector or governmental employer community is relatively small proportionate to the nation's approximate 6.5 million employers, this community is a critical Internal Revenue Service (IRS) stakeholder and has very significant interactions with the IRS. According to the 2002 Census of Governments--GC02-1 (P) issued July 2002, there are approximately 88,000 governmental entities in the United States as of June 30, 2002.

Public employers have long acknowledged and 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. The Department of the Treasury and the IRS recognized that "governmental employers" represent a special and diverse community. The establishment of the Tax Exempt/Governmental Entities Division (TE/GE) and its Federal, State and Local Governments (FSLG) component acknowledged that public entities present unique needs and operational considerations.

The report that follows represents the third in a series of ACT reports addressing TE/GE and FSLG's organizational and functional development. The first two ACT reports offered numerous recommendations designed to facilitate a new organizational approach to servicing tax exempt entities and governmental employers. The ACT perpetuates and facilitates the on-going need for IRS and its stakeholders to view tax compliance and administration through a partnered vision. To its credit and as evidenced by follow up actions to previous recommendations, TE/GE fully embraces ACT involvement and the mutual benefits that partnered opportunities present.

The team approached this project through a variety of informational gathering methods and direct interviews with affected entities comprising the primary public sector employer and IRS interfaces. The underlying review was tied to a single concept—what, if any opportunities exist for FSLG and other IRS/Treasury entities to advance voluntary public sector employer compliance as expressed by state and local government employers. The recommendations resulting from this effort are presented in three major areas summarized below. Each area addresses a central opportunity as well as specific recommendations embracing barrier removal concepts. FSLG should remove barriers within its purview and, as well, advocate similar action by other IRS entities for crossover issues on behalf of its stakeholders.

This document provides a snapshot of state and local government sector employer views on the current employment tax environment. It identifies tax compliance barriers recognized by public employers across the nation as well as from IRS entities supporting this market segment. These barriers stem from legislative and budget decisions through the administrative remedies/structures used to implement those decisions. The issues, problems and resulting recommendations provide an

informational platform for IRS entities including FSLG to re-examine, re-engineer and re-energize IRS business practices. Although a number of recommendations crossover into other IRS and Treasury entities, this report provides FSLG with information to advocate its customer's needs, advance services and promote voluntary tax compliance. We realize that FSLG could not accomplish all of the recommendations on its own, but we also realize that FSLG is on the "front line" for its customers. We believe FSLG should serve as an advocate to IRS and other Treasury entities when FSLG becomes aware of fundamental customer needs that are not being met. For that reason, we have chosen to include that type of recommendation in this report.

Partner with the public employer community

In this section, we have identified a number of recommendations that FSLG can independently achieve.

- **Recommendation**: FSLG market its web site directly to its stakeholders via the 13 national organizations and associations representing those stakeholders. Encourage stakeholders to promote FSLG site use/subscriptions with their members. TE/GE should also market the FSLG website in its materials.
- **Recommendation**: FSLG create a combined FSLG/Stakeholder work team to partner in subsequent web site/newsletter design, application and content development efforts. FSLG actively engage its customers to participate and share in an on-going ownership in FSLG products affecting employment tax roles.
- **Recommendation**: FSLG adopt stakeholder participation in IRS initiatives as a vital program objective; institute an on-going stakeholder work group to review IRS initiatives affecting stakeholders; provide timely feedback and promote information sharing.
- **Recommendation**: FSLG actively monitor inter-divisional initiatives (SB/SE, W & I, and LMSB) affecting FSLG stakeholders and advance stakeholder perspectives to insure end-to-end accountability from "idea to implementation".
- **Recommendation:** FSLG establish tangible customer service standards for both written and telephone customer inquiries. FSLG should annually measure its customer service performance by applying these standards and publicize the results in the Winter FSLG Newsletter.
- **Recommendation:** FSLG "place a face" in its public brochures and via its web site to those IRS entities that interface with public sector employers. The product should identify the players and illuminate a brief description of their respective functionality.
- **Recommendation**: FSLG adopt an opportunistic customer initiative strategy that "piggybacks" FSLG customer needs on other IRS divisional initiatives and eliminates sole reliance upon FSLG to represent customer needs. FSLG begin implementing this strategy using the Form 941/941c and refund issues.

Dismantle compliance barriers through identification of barriers

In this section, we have identified a number of recommendations that we realize FSLG cannot achieve on its own. However, these recommendations involve items that are critical for state and local governments to be able to timely comply with their responsibilities as employers. It is our recommendation that FSLG become actively engaged in intra-Service discussions about these items to ensure state and local government concerns are considered. These issues strike to the essence of the state and local government relationship with the federal government in their role as employers.

- **Recommendation**: IRS expand the Form SS-4 (Application for Employer Identification Number) process to collect every new employer's e-mail address. The form identifies and IRS categorizes the employer as an SB/SE, W&I, LMSB or TE/GE customer. With those two pieces of data, IRS should automatically subscribe a new employer to the appropriate IRS website(s).
- **Recommendation**: IRS establish a central entity to track the timely release of annual tax information, including non-IRS parties which annually provide tax data, within an annual cycle which insures prospective tax implementation.
- **Recommendation**: IRS adopt as a servicewide policy to immediately provide interim direction whenever release of annual tax information is unavoidably delayed and provide a corresponding safe harbor for employers using this interim direction.
- **Recommendation**: IRS review and adjust its communication systems to insure that stakeholders receive adequate advance notification of operational changes, including impacts employers will experience when implementing those changes.
- **Recommendation:** IRS re-evaluate its publication program to insure the program:

    1. Empowers state and local government employers to properly execute tax responsibilities without subscribing to ancillary informational services;
    2. Provides an efficient and timely update process, which bypasses unnecessary IRS reviews/delays prior to publication;
    3. Encompasses formal governmental employer stakeholder and interdivisional/IRS organizational ownership of employer based publications; and
    4. Requires all publications affected by new rulings to reflect any new requirements stemming from those rulings.
- **Recommendation**: IRS adopt as a servicewide standard that all correspondence to state and local governments identify the appropriate operating division name (or highest organizational nomenclature) as well as the specific sub-organization of the division generating correspondence.
- **Recommendation**: IRS adopt as a servicewide standard that all correspondence to state and local governments provide a "subject description" that identifies the basis for the communiqué, which meets the "common person" test.

Correspondence must contain a concise statement outlining why an addressee is being contacted—a statement that any common person would readily understand.

- **Recommendation**: IRS assign a basic tracking code (date request is received) or indicator (description on the refund) that readily ties a state or local government employer's specific refund request to the corresponding issued refund check. Provide an explanation regarding the refund amount including the interest computation—a formula, number of days interest was paid, or inclusive dates the interest represents.
- **Recommendation:** IRS review its refund production cycle and initiate corrective measures to address communication shortfalls and implement a refund standard that returns state and local government employer funds with the same time sensitivity as IRS requires regarding underpayments and penalties.
- **Recommendation:** TE/GE, using its various newsletters, publicize IRS corrective measures and customer service tax refund standards.
- **Recommendation:** IRS review the Master File address change process as to state and local governments and implement safeguards to preempt erroneous address changes.

- **Recommendation:** IRS implement an expedited corrective process that rectifies inadvertent Master File errors on state and local governments within five workdays and provides an electronic media/outreach training program for state and local employers addressing this business problem.
- **Recommendation:** FSLG in conjunction with stakeholder participation, identify five tax regulations whose subjective requirements (such as de minimis fringe benefits) represent the most frequent compliance barriers to state and local government stakeholders. Working through the other IRS divisions and Chief Counsel, recommend projects via the IRS Priority Guidance Plan to address and replace subjective standards to the extent possible, with objective standards that promote independent tax compliance.

Adopt the concept of voluntary compliance through barrier elimination as a strategic focus for customer services and regulatory actions.

In this section, we identified two recommendations that FSLG and the Service should advance.

- **Recommendation**: Servicewide, IRS "value" its state and local government stakeholders' perspectives regarding compliance barriers and use barrier removal as a strategic focus for advancing voluntary compliance and customer services.

- **Recommendation**: Federal, state and local governments should have identical compliance remedies consistent with the IRS mission "to apply tax law with integrity and fairness to all".

The ACT encourages FSLG to embrace a cultural ethic for barrier-free tax administration. FSLG and other IRS entities along with state and local government

employers can create mutually beneficial relationships exponentially to the growth of voluntary compliance. This growth can be powered by the elimination of tax compliance barriers. Sustained and viable relationships mandate that all parties "value" voluntary compliance. Each must actively work hand in hand to remove policy, procedural, structural and other communication shortcomings plaguing employment tax administration today.

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Introduction

Although the public sector or governmental employer community is relatively small proportionate to the nation's approximate 6.5 million employers, this community is a critical Internal Revenue Service (IRS) stakeholder and has very significant reporting, taxation and other interaction with IRS. According to the 2002 Census of Governments—GC02-1 (P) issued July 2002; there are approximately 88,000 governmental entities in the United States as of June 30, 2002.

A governmental entity is defined as "an organized entity subject to public accountability, whose officials are popularly elected or are appointed by public officials, and which has sufficient discretion in the management of its affairs to distinguish it as separate from the administrative structure of any other governmental unit". The U.S census recognizes seven basic types of government: federal, state, county, municipalities, townships, school districts and special districts.

Federal, State and Local Government (FSLG) defines its customer market segments into four groups: federal agencies, state agencies, local governments and quasi-governments. FSLG likewise views governmental associations and governmental practitioners as customers. For employment tax purposes, FSLG projects that public employers employ approximately 20% of the American workforce. According to the IRS 2002 Databook, the combined-annual federal employment tax liability for these employers/employees is approximately $200 billion or 14.3% of the nation's annual employment tax liability of $1,390,478,688,000.

The public employer community, unlike its private sector counterpart, does not exist on a profit center model or for a profit motive. Rather, governmental employers serve very specific social needs, e.g. education, public safety, etc. and act as guardians of the "public trust". Governmental entities have severely restricted financial means. All funding and expenditures are continuously subject to public review and scrutiny. The public employer community can ill-afford the political and financial consequences of non-compliant tax behavior. Nor can it afford to operate in a tax environment imposing unnecessary administrative barriers, which in turn promote non-compliant behavior.

The Department of the Treasury and the IRS recognized that "governmental employers" represent a special and diverse community. The establishment of the Tax Exempt/Governmental Entities Division (TE/GE) and its FSLG component acknowledged that public entities present unique needs and operational considerations. These realities present formidable challenges to IRS in meeting its stated mission" to apply the tax law with integrity and fairness to all". This is especially true given the significant absence of IRS interfaces with public sector employers prior to the IRS Restructuring and Reform Act of 1998. Today, FSLG still remains largely an unknown entity within the public employer community.

In late September 2003, Pamela Olson, the Treasury Department's assistant secretary for tax policy stated that IRS is using three fundamental strategies to encourage tax

fairness, compliance and simplicity. These strategies include: better communication, reducing disputes and rationalizing the tax system to make the system simple and meaningful. The ACT suggests adding to this three-prong strategy a critical denominator for governmental employers--empowering governmental entities to **independently** achieve compliance. This requires federal tax authorities to identify and then resolve situations where they create barriers that impede voluntary compliance.

Ms. Olson also stated that "IRS made the mistake of letting litigation function as a rulemaking process" further pointing out " understandings of the tax code generated through litigation do not serve the goals of tax fairness and consistency." The assistant secretary went on to conclude that better information in the hands of taxpayers reduces disputes and advances compliance. Litigation is often born through costly and contentious assessments tied to inadequate communication. Audits and downstream litigation are driven in large part by the failure to communicate and desire to maintain the familiarity of a status quo environment.

Public employers have long acknowledged and 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 that prevent voluntary compliance. Public employers, unlike many of their private sector counterparts, do not view employment tax administration from a profit center motive. Rather, it is a required business function that is best served through objective and timely execution of clear, concise, and reliable requirements. Public sector employers seek solution-based alternatives, which meet the letter of the law.

Conversely, the private sector may be more willing to explore "the compliance envelope" as a business strategy. These employers navigate the challenging tax landscape to determine their fair share of taxes. At times, they also appear readily to accept the consequences for non-compliance and tax avoidance. To the private sector, these consequences are legitimate operating costs, including litigation. At no time can the public sector take that point of view--given state statutes governing public employee behavior and ethics.

This document provides a snapshot of state and local government employer views on the current employment tax environment. It identifies tax compliance barriers recognized by public employers across the nation as well as from IRS entities supporting that market segment. These barriers stem from legislative and budget decisions through the administrative remedies/structures used to implement those decisions. The issues, problems and resulting recommendations provide an informational platform for IRS entities including FSLG to re-examine, re-engineer and re-energize IRS business practices. Although several recommendations crossover into other IRS and Treasury entities, this report provides FSLG with information to advocate its customer's needs and advance services to promote voluntary tax compliance.

The ACT encourages FSLG to embrace a cultural ethic for barrier-free tax administration. The ethic should embrace a voluntary compliance model tied to both IRS induced as well as externally created barriers. As a business practice, FSLG and other IRS entities should assess products, services and guidance as either "barrier creators" or "compliance enhancers." This determination should be made in the modeling phase and not after imposition via implementation. FSLG should encourage stakeholder participation in defining customer service, identifying barriers and securing their resolution. Stakeholders should also bring focus to externally created barriers such as legislative and budgetary decisions that impede voluntary compliance.

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Background: Progress To-Date

This represents the third in a series of ACT reports addressing TE/GE and FSLG's organizational and functional development. The first two ACT reports offered numerous recommendations designed to facilitate a new organizational approach to servicing governmental employers. The establishment of TE/GE and FSLG in 1999 was a critical and essential acknowledgment that the IRS had underserved tax exempt and governmental entities in prior IRS organizational designs.

The ACT perpetuates and facilitates the on-going need for IRS and its stakeholders to view tax compliance and administration through a partnered vision. To its credit and as evidenced below, TE/GE fully embraces ACT involvement and the mutual benefits that partnered opportunities present.

TE/GE operates in a highly diverse and dependent environment. Administratively TE/GE is one of four primary IRS operating divisions. Unlike the other three divisions, TE/GE does not address a single class of customers. Rather, TE/GE services an extremely diverse customer base whose program needs are complex and largely uncharted. The other three operating divisions--Wage and Investment (W&I), Small Business and Self Employed (SB/SE), and Large and Mid-Size Business (LMSB)--service a common client base. SB/SE and LMSB likewise provide long standing, crossover program services such as examination, collection, and return processing for their customers as well as for TE/GE customers. The "shared" nature of TE/GE's customers directly places additional liaison, coordination and information sharing burdens onto TE/GE and its customers.

To communicate, represent and service its customers' needs, TE/GE must secure support through various IRS entities and navigate their respective bureaucratic structures. TE/GE also shares its customers with other IRS entities such as Governmental Liaison and Disclosure, Office of Chief Counsel, and Taxpayer Advocate, which maintain jurisdictional control over programs and operational responsibilities that directly impact TE/GE and its customers. TE/GE's end-to-end accountability, when articulating and successfully implementing its customers' needs, is severely tested within this dependent environment.

As an organizational newcomer, FSLG was allocated limited budgetary resources. These resources are inherently deficient to meet known and desirable program needs. All resources must be applied judiciously with an eye for maximizing value-added programs while meshing with the Commissioner's and other IRS competing priorities. To illustrate, FSLG has fewer than 95 employees. Approximately 64 FSLG Specialists are expected to provide an array of employment tax, reporting and compliance services to over 88,000 entities--1: 1375 ratio. Further compounding the ratio imbalance is the fact that these 64 Full Time Equivalents (FTEs) cover the geographical United States.

Logistically, it is virtually impossible to provide quality services to state and local government employers given the resource and spatial relationships. Employers rated

FSLG's Customer Support in eight areas with the highest satisfaction area (55.1%) for "available for assistance". Only 18.9% were satisfied with FSLG's "partner to remove compliance barriers" and 26% to "deliver appropriate technical training". Further, 75.1% of the responding employers indicated "no experience" with FSLG in "partner to remove compliance barriers" or 45.6% regarding "timely turnaround on issues". With the current budgetary environment, it is very difficult for FSLG specialists to be proactive in addressing customer technical needs nor establishing effective, ongoing customer interfaces.

It is against this backdrop of obstacles and opportunities that TE/GE seeks to excel. The following examples reflect recent advancements made within one TE/GE component--FSLG--and illustrate the success of the TE/GE-ACT partnership.

First, FSLG has made significant strides in creating its customer inventory database. There is no single greater need and goal than for FSLG to fully know its customer segment and its issues. The FSLG database now identifies over 87,900 customers and its initial construction phase was finished January 2004. Thereafter, FSLG turned its attention to maintaining an accurate and current database, which addresses customer's needs. (Note: the IRS Business Master-file increased over 15% between June--December 2003 to 80,828 identified return fliers. FSLG is fast reducing the number of unknown customers as evidenced by this growth.

The ACT's 2002 recommendation encouraged FSLG to ensure that both state and federal partners could derive benefits from the database to enhance business practices. More specifically, the ACT suggested that IRS and the Social Security Administration (SSA) apprise States when new public employers were established, especially from the perspective of Section 218 Social Security Act provisions. In November 2003, the National Conference of State Social Security Administrators (NCSSSA) endorsed this recommendation and requested its implementation by 2004. (Note: the NCSSSA is one of several primary stakeholders that would directly benefit from this capability.) FSLG acknowledged on December 18, 2003 that it had implemented the ACT recommendation. FSLG's performance received solid marks from the affected stakeholders and represented quality customer service.

Second, FSLG instituted several communication vehicles--some targeted internal needs and some (like the FSLG web site) targeted its external stakeholder audience. FSLG's Director implemented a monthly newsletter to the field staff. The letter highlights new developments that directly impact Specialists and their customers. Although a subtle change, the recap reinforces the need for communication links between FSLG line and staff functionality. The letter does not eliminate all information gaps, however it accelerates information sharing and underscores the value of routinely connecting the FSLG team. The establishment of the FSLG web site was another TE/GE--ACT collaboration. This site provides the first external vehicle wherein FSLG's customers can directly access/interact with their IRS counterparts. On-line access promotes customer use--the value of that use is consistent with the site's informational parameters. As identified later in this report, additional consideration to the site is

warranted. However, FSLG receives positive marks for this service and for recognizing, as do state and local government employers, that a web site properly defined and managed is an invaluable asset for voluntary compliance.

Other notable developments stemming from the TE/GE--ACT partnership via FSLG include:

- proposing a Voluntary Closing Agreement Program for governmental employers;
- clarifying further the roles and responsibilities of FSLG Specialists;
- affirming the TE/GE Call Site as the "point of entry" for stakeholder inquiries;
- reestablishing ongoing meetings with the SSA pursuant to the 2001 IRS/SSA Memorandum of Agreement to address a myriad of coverage and service-based program issues stemming from Section 218;
- establishing customer services standards wherein each of the 50 states and their employment tax accounts are assigned an individual account liaison. The account liaisons reside at the Ogden Service Center and maintain direct contact with each state and address account related services regarding payroll tax deposits, returns and reporting. The Ogden/state liaison model has proven highly effective and demonstrates that mutually beneficial results for IRS and its customers can be achieved through routine communication and timely outreach;
- creating standardized and specific audit technique guidelines based on three market segments, federal, state and local governments; and initiating FSLG participation in the Annualized 941 work group whose mission crosses division lines.

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Opportunities

The following areas provide opportunities to advance federal tax administration goals and address FSLG customer issues. These opportunities reflect a broad playing field wherein FSLG can remove compliance barriers. FSLG should also advocate action by other IRS entities regarding crossover issues that can readily promote cost effective, proactive and voluntary employment tax compliance via the public sector employer community. The opportunities noted fully embrace the three IRS fundamental business strategies cited by Treasury's Assistant Secretary for tax policy: tax fairness, compliance and simplicity.

- **Partner with the public employer community**

As reflected in the previous ACT reports, the initial thrust of FSLG activities encompassed organizational structure, staffing and implementing core operations. Those priorities precluded significant cultivation of interactive stakeholder relationships. These relationships are critical to advancing IRS goals as well as maximizing FSLG's scarce resources. Of the thirteen groups identified as likely FSLG stakeholder groups, only two appeared to actively work with FSLG prior to 2004 to illuminate actual market segment needs. The majority of the 13 stakeholders and their clients do not know or have not experienced FSLG in any meaningful interface. FSLG's outreach initiative in 2001-2003 fell short of its published goals of contacting each public employer and providing outreach services. Those who interfaced with FSLG reported wide variances between the nature and scope of these interfaces. The majority of state and local government employers were never contacted by this initiative. These employers remain wary of FSLG. They still perceive an inability to affect and secure any meaningful voice in services rendered by IRS.

FSLG's perspective of "market segment needs" remains largely "home grown" versus actual requirements delineated by employers. FSLG can address this and other barriers by expanding its marketing and informational services. It should actively partner with its customers (including governmental associations and governmental practitioners) and advocate their perspectives. FSLG's stakeholders should be an integral asset in assisting FSLG to review and investigate emerging issues and then, champion mutually advantageous endeavors.

TE/GE and FSLG confront many organizational obstacles including sharing their customers with other IRS entities whose organizational loyalties and/or priorities differ. Further, FSLG is unquestionably understaffed given its mission and vast, complex market segment. This market segment--both established governmental entities and new governmental employers--still have minimal knowledge of FSLG and the "new and improved IRS". The 1998 IRS Restructuring and Reform Act created direct IRS interfaces for public sector employers and now six years later, those interfaces remain elusive.

Though FSLG is dependent upon W&I, SB/SE, LMSB and Chief Counsel for many user activities such as customer account services, examination, collection and guidance, FSLG should aggressively use these organizations to address its clients' issues. FSLG can readily "piggyback" on other units/divisions initiatives to address public employer's needs and/or eliminate compliance barriers stemming from other IRS areas. To do so, requires FSLG to view compliance and information sharing from both an IRS and its client's perspective.

The first step requires FSLG to cultivate interactive relationships with its stakeholders and effectively act upon those relationships.

- **Dismantle compliance barriers through identification of barriers**

No matter how many employment tax laws Congress enacts or rules and regulations IRS issues, compliance cannot occur without a viable employer/IRS partnership. For this partnership to work, **all facets** of IRS must recognize that "how they do business" directly affects business success. Though FSLG cannot independently address and dismantle all compliance barriers, FSLG and TE/GE can advance crossover stakeholder issues to the appropriate IRS and Treasury entities for consideration.

Promulgating overtly complex regulations may "meet the test of law" and provide technically correct interpretations. However, regulations that are not routinely applied accurately or consistently make the regulatory process irrelevant. Providing inadequate guidance/insufficient training/questionable informational services inhibit compliance. Likewise, releasing guidance and necessary employment tax information untimely are formidable compliance barriers. **Business practices predicate business results.**

As recorded at the January 26, 2004 IRS Oversight Board hearing, organizations such as the American Bar Association (ABA) and the Tax Executive Institute stated that tax code simplification is needed for IRS to administer the tax system effectively. ABA Chairman of Taxation, Richard Shaw, stated, "Complexity creates significant obstacles to efficient and effective tax administration. It imposes substantial burdens on taxpayers that attempt to comply with the law; it has reduced the perceived fairness of the tax system; and it has created opportunities for tax abuses, forcing IRS to divert resources from compliant resources to enforcement. Simplification is not only a legislative responsibility, the IRS and Oversight Board must move things forward".

Tax administration is not advanced for state and local government employers (particularly when acting in their employment tax role) when IRS staffs are as equally confused about tax requirements as the employers that they assist. Tax administration cannot advance in this environment--it is gridlock.

The second step in eliminating barriers is to identify barriers to the responsible entities.

- **Adopt the concept of voluntary compliance through barrier elimination as strategic focus for customer services and regulatory actions**

Servicewide throughout the IRS culture, as evidenced by its publications, outreach and compliance efforts, voluntary compliance is frequently projected as an external activity--one performed by individuals and employers. Our surveys and discussions with employers found that state and local governmental entities do not perceive that the IRS collectively or through individual divisions embraced voluntary compliance as a legitimate internal IRS activity. TE/GE represents an exception to this finding. TE/GE has recently demonstrated within its Employee Plan program that voluntary compliance can be highly successful when approached as an IRS activity explored through cooperative efforts with its stakeholders.

In November 2003, the IRS Oversight Board released its "Annual Survey on Taxpayer Attitudes" conducted by RoperASW. The survey noted that "fear of an audit" is a major influence on tax compliance. However, the survey noted that the strongest influence on tax compliance is personal integrity. Of those surveyed, 73% considered it a "major influence" while another 15 % considered it "somewhat of an influence". These findings reinforce that voluntary compliance is readily obtainable if the environment for compliance is favorable. Conversely, audits produce fear. IRS may instill fear by demonstrating its ability to detect non-compliance and discourage the risk-reward calculus by those pushing the envelope. Fear also stems from a lack of confidence in performing tax roles. Through no fault of the taxpayer and/or employers, fear is produced by the "uncertainty" of applying ambiguous IRS rules, regulations etc.

Commissioner Everson readily concedes that our tax system involves complex rules and fine legal judgments. In his comments before the Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs he stated, " the tax laws are complex and taxpayers are permitted to take aggressive positions within the bounds of law". Neither the Roper survey nor IRS has addressed how much fear is derived from a hostile compliance environment. Public employers, in spite of their fiduciary responsibilities that preclude making a gift of public funds, inadvertently over-pay tax liabilities because they do not understand the rules and/or are afraid to make a mistake.

As a primary means to tax fairness, IRS must "value" voluntary compliance. It must recognize that voluntary compliance is best served by capitalizing upon the personal integrity of public sector employers and via elimination of IRS created compliance barriers. Tax fairness from IRS must also extend to all governmental employers—federal, state and local governments—through consistent and equitable treatment. Through TE/GE and FSLG leadership, it can demonstrate to other IRS and Treasury entities to view voluntary compliance as a critical internal business practice. TE/GE should approach business practices not from "business as usual", but rather "business through barrier removal". Likewise, governmental employers must actively participate--

they must embrace an active partnership role in identifying barriers and offering viable solutions.

The third step is to recognize that IRS must maintain an ongoing business strategy that values voluntary compliance through elimination of IRS created compliance barriers.

Methodology

The team approached this project through a series of informational gathering methods and direct interviews with affected entities comprising the primary pubic sector employer and IRS interfaces. The participants included: TE/GE staff, FSLG Director, Office of Outreach, Planning and Review (OPR), FSLG specialists, SB/SE Ogden Campus, Wage and Investment Division (W&I), Office of Chief Counsel, and a diverse cross-culture of the state and local government employers. The underlying review was tied to a single concept--what, if any opportunities exist for FSLG and other IRS/Treasury entities to advance voluntary public sector employer compliance as expressed by public employers.

The team's first step was to review ACT Reports I/II and related TE/GE and FSLG publications, information sources such as the Internal Revenue Manual 4.90, etc. These activities did not reveal that FSLG had actively assessed its impact on voluntary compliance. The team noted that most attention in addressing voluntary compliance stemmed from IRS expectations that with proper employer education, compliance could be achieved. To date, we have yet to discover any assessment measuring the effects (success or failure) of FSLG actions and services upon the public employer community's tax compliance performance.

For example, FSLG was to provide outreach to its market segment from 2001-2003. FSLG did not maintain statistics regarding individual governmental entities contacted. For Fiscal Years 2002 and 2003, FSLG stated it conducted 1525 outreach events with 83,820 attendees. This represented an event to attendee ratio of 1:55. The nature of these events and how many attendees actually represented unique state and local governmental employers are unknown. During this same period, FSLG indicated it responded to 8543 telephone inquiries. FSLG was unable to categorize the nature of the calls, geographical location and type(s) of outreach resulting from the calls. FSLG apparently did not solicit/quantify employers' needs or identify compliance barriers that outreach efforts were to address. Employer feedback from across the nation suggests that typical outreach activity encompassed a phone call indicating that a FSLG Specialist was assigned to an area versus actual outreach and training sessions. There was also no apparent follow-up measurement of outreach effectiveness then or now.

Based upon these and other informational responses, the team pursued a more in-depth data capturing exercise. Three perception or feedback documents were developed. The first document was tied exclusively to FSLG's national state and local government employer base. As with each feedback document, a draft was provided and critiqued by a user group and then by IRS. The focus group review addressed clarity and content issues; IRS review was principally designed as informational sharing. The team then selected a cross section of employer based organizations to complete the document.

Thirteen organizations were considered: American Institute of CPAs, American Payroll Officials, Employee Benefits Security Administration, Federation of Tax Administrators,

Governmental Finance Officers Association, National Conference of College and University Business Officials, National Association of Counties, National Association of State Auditors, National League of Cities, National Conference of State Social Security Administrators and National Association of Towns and Townships. The selected entities represented either clients who most likely performed traditional employer roles and responsibilities and/or those most likely not represented via other IRS sanctioned forums. Participating organizations included: National Conference of State Social Security Administrators; National Association of State Auditors, Controllers and Treasurers; National League of Cities; National Association of Counties (National Association of County Treasurers and Finance Officers) and National Association of College and University Business Officials.

Feedback documents were then distributed to a representative sample of each selected organization's membership. In addition, another 50 political subdivisions residing in one central state received the employer survey. The political subdivisions were primarily small, medium and large sized cities and boards of education. A total of 650 employers representing all 50 states were surveyed and 238 (36.6%) completed documents. The composite results of this effort are reflected in Exhibit A.

The second document targeted the IRS staff charged with providing compliance assistance to the public employer community, the FSLG specialist. The specialists represent the primary and essential link to state and local government employers--an ideal informational source for transcending compliance issues encompassing both IRS and customers' perspectives. The specialist compliance document especially targeted employer-based services and customer interfaces. All FSLG specialists, approximately 64, received feedback documents and 15 completed those documents. The 23.34 % response rate was disappointing given the subject matter and confidential nature of the feedback. The response rate may be indicative of other issues outside this project's scope. The composite results are reflected in Exhibits B. The team also reviewed and considered data secured via two previous IRS sponsored surveys: 2001 Climate Survey and TE/GE 2003 Survey.

The third document sought feedback from the SB/SE Ogden Campus staff which processes public sector employers' reporting and payment documents. The project team worked with Teams 1 and 2 of the SB/SE Accounts Management, Large Corporations, and TaxPayer Relations. These teams' customers are "LCI" coded entities representing about 230 governmental employers. The employers are entities that had previous compliance issues and/or large employers such as States whose accounts are each assigned a specific account representative. As the final processing stop, the Ogden data illustrated in broad terms both the success and shortcomings tied to compliance barriers. Approximately 15 team members received feedback documents and 12 (80%) returned documents. The composite results are reflected in Exhibit C.

The team also contacted various other IRS organizations and conducted interviews with entities such as Compliance Services--Fresno Questionable W-4 Program, Office of Chief Counsel--Income Tax and Accounting and TE/GE and SB/SE divisional staff in

the Office of Taxpayer Burden Reduction. These entities had either developed services for FSLG customers and/or provided venues for employer information sharing. The interfaces were designed to generally assess communication between FSLG and other IRS units--was FSLG actively seeking opportunities to secure and advocate its market segment views.

The project team's efforts were designed primarily to provide a window on the customer's world--view that captures "today's" environment. It provides TE/GE and FSLG an independent state and local government employer view of IRS--a perspective that demonstrates that current IRS business practices can be unnecessary compliance barriers.

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Discussion

The state and local government employer market segment sees voluntary compliance in part, as a by-product of the IRS overall tax environment. The environment is viewed as cumbersome, complex, unresponsive and ill disposed for voluntary compliance. Employers echoed a common theme "that IRS needs to create a compliance barrier-free tax environment". This sentiment was further supported by Nina E. Olson, National Taxpayer Advocate. In her National Taxpayer Advocate's 2003 Annual Report to Congress, she stated," IRS resources must be applied in a way that achieves a reasonable balance between enforcement activity, on one hand, and customer service and taxpayer rights, on the other". She went on to say, "Congress and the IRS need to undertake more thorough research to ensure that legislative and administrative responses to perceived problems in tax administration are rooted in fact rather than impression or anecdote, and that initiatives actually achieve what they are designed to accomplish".

The project team acknowledged that these and other employer perceptions were sufficient to conduct this and possibly subsequent ACT reviews. This report highlights a potpourri of opportunities and recommendations, which address these opportunities. For the IRS and its recent reorganization to be successful via the TE/GE and FSLG structures, compliance barriers must be removed. This document identifies a range of barriers within a fertile employment tax environment versus a compilation of a definitive barrier universe. The report encompasses IRS/Treasury entities and is designed to open minds to possibilities rather than to limit minds and possibilities to a single report.

For ease of review, the Discussion segment is broken into three areas. Each area addresses a central opportunity, including findings tied to each opportunity as well as specific recommendations embracing barrier removal concepts. Recommendations are directed to both IRS and Treasury entities; they also provide FSLG with information to advocate its customer's needs, advance services and promote voluntary compliance.

Partner with the public employer community.

Given the multitude of obstacles confronting FSLG, it can ill-afford to maintain passive relationships with its primary stakeholders. By actively and aggressively engaging business partnerships, FSLG is better poised to maximize its scarce resources. Stakeholder involvement has proven time and again to be an effective medium to advance mutually beneficial tax administration goals. Early and frequent cooperation allows IRS to draw from the experience and expertise of its customers to administer more effective programs and oversight resolutions.

Clearly, establishing and staffing FSLG consumed its early existence. With that phase nearly completed and the internal IRS expectations for compliance growing, FSLG must cultivate stakeholders and recognize the value they offer. Feedback from state and local government employers in late 2003 reflected the absence of a meaningful FSLG relationship. Until some preliminary efforts in January 2004, there was no ongoing,

formalized relationship between FSLG and most of its stakeholders. The ACT at the January 2004 session encouraged GE/FSLG executives to establish work groups from FSLG's primary stakeholders to assist FSLG on "public employer impacting" IRS initiatives. Work groups could not only act as an invaluable informational source, but also allow FSLG to concurrently consider federal, state and local government viewpoints.

To illustrate, the following are a few candidates for partnership consideration.

- **Inadequate Stakeholder awareness of FSLG's Web site**

Problem: FSLG's new web site remains a largely unused informational platform. State and local government employers are unaware of the site, which may be attributed in part to its newness. As of September 2003, FSLG's Office of Outreach, Planning and Review reported that 4,269 entities subscribed to the FSLG list serve and the number of "page visitations" was 35,432 between April and June 2003. FSLG stopped recording visitation statistics effective June 11, 2003. E-mail subscriptions rose by December 2003, to 5310--approximately a 26% increase. The ACT attributes a portion of this increase to its inadvertent marketing of the FSLG site via its contact with stakeholders and the state and local government employer survey process. The feedback document asked employers to assess the FSLG and other IRS online products--in doing so; employers reviewed the site and subsequently subscribed. At the conclusion of the survey period in February 2004, the E-mail subscription had risen to 6091 or a 14.7% increase over the December 2003 rate.

These figures are encouraging yet still represent marginal growth relative to FSLG's overall 88,000-customer base. Employer feedback paralleled these findings, as 81.7% of respondents indicated neither knowledge nor experience with the nine primary on-line IRS communiqués including FSLG's site (78.6%).

Recommendation: FSLG market its web site directly to its stakeholders via the 13 national organizations and associations representing those stakeholders. Encourage stakeholders to promote FSLG site use/subscriptions with their members. TE/GE should also market the FSLG website in its materials.

- **Stakeholder exclusion from FSLG's Web site marketing and newsletter content**

Problem: The most recent FSLG website redesign (winter 2003) was created with minimal if any customer involvement as to "marketing" the site. Though FSLG perceived this revision as structural, customer participation would have been extremely beneficial even if only to establish stakeholder communication links. Unlike the highly successful Employee Plan News produced by TE/GE's Employee Plan staff with active stakeholder participation, FSLG's Newsletter lacks meaningful stakeholder participation.

FSLG's web site and related quarterly newsletter exist primarily as informational sources to FSLG's stakeholders. If the stakeholders are not active participants in establishing and identifying their informational needs, then these products may be neither relevant nor likely to be utilized. FSLG customers must identify a "business value" to the site and the newsletter for each product to be successful. FSLG can advance "business value" by listening to its customers, embracing their ideas and marketing superior products.

To illustrate, FSLG specialists created several training products involving Fringe Benefits, Independent Contractors, and 1099 reporting that received outstanding endorsements from employers and stakeholder groups. These products were deemed superior to several IRS publications covering the same subjects. The FSLG products were written in "real world" terms in cooperation with stakeholder input. The products advanced voluntary compliance as they encompassed the employers' perspective and facilitated their tax administrative roles. Stakeholders began requesting in mid 2002 that these materials be placed on the FSLG web site. In doing so, state and local government employers could use these references and even self-train as an alternative to waiting for FSLG outreach. By FSLG making these materials directly available to employers, employers would be empowered to pursue voluntary compliance.

Stakeholders also strongly recommended that these training materials be provided/used by all FSLG specialists. With this approach, public employers across the nation would receive the same quality and consistent information needed to do their jobs. These tools would also minimize any expertise shortfalls by specialists lacking this technical expertise. (Note: sixteen former revenue officers occupy specialist positions--25% of the total sixty-four field based specialist positions. These former revenue officers' expertise was more narrowly aligned with collection activity and not the broader employment tax and related outreach/training functions now performed by specialists.)

Late in 2003 and with over a year of recurring stakeholder activism, these goals were achieved. Ultimately the training materials were made available to all FSLG specialists via FSLG's internal LAN based system and governmental employers via the public FSLG web site. It remains unclear however, if all specialists are required to use these materials when training.

When FSLG implemented these web site additions, it unfortunately did not market its action to either staff or its stakeholders. Whether by oversight or by design, failure to acknowledge these products, their availability and value represented a strategic shortfall. Stakeholders and specialists were surprised by FSLG's apparent reluctance to market successful products and customer services.

Recommendation: FSLG create a combined FSLG/Stakeholder work team to partner in subsequent web site/newsletter design, application and content development efforts. FSLG actively engage its customers to participate and share in an on-going ownership in FSLG products affecting employment tax roles.

- **Insufficient participation by public sector stakeholders regarding new initiatives services that directly impact employer's daily, quarterly or annual employment tax responsibilities**

Problem: FSLG stakeholders lack effective participation and a voice in IRS crossover initiatives that impact their tax roles and customer needs. Lack of representation of public employers remains a serious problem. The magnitude of this oversight will manifest into a highly visible IRS deficiency as compliance checks and audits occur. State and local government employers could ultimately use the absence of representation as a political medium to mandate additional IRS reform.

Public employer stakeholder and professional associations are rarely considered or consulted when IRS entities (other than FSLG) undertake structural reviews or initiatives. Presently, FSLG customers are unlikely to know about other IRS entity activities that directly impact them. For example, the majority of state and local governmental employers do not know about the Office of Taxpayer Burden Reduction (OTBR) within SB/SE Division. OTBR's mission is to achieve a significant reduction in unnecessary burdens for all taxpayers by targeting six areas:

- Simplifying forms, publications and notices;
- Streamlining internal policies, processes and procedures;
- Promoting less burdensome rulings, regulations and law;
- Developing burden reduction measurements;
- Partnering with all stakeholders to identify/address burden initiatives; and
- Chairing Taxpayer Burden Reduction Council (TpBRC) that coordinates IRS burden projects.

All IRS operating divisions, not only SB/SE, are represented on the TpBRC and can submit burden initiative recommendations through normal management channels to their TpBRC representative. FSLG has yet to submit initiatives to the TpBRC since TpBRC's first meeting on October 1, 2002. Nor, does it appear that any FSLG stakeholders have used this forum to address issues. Stakeholders can submit Forms 13285A--Reducing Tax Burden on America's Taxpayers--to the TpBRC. As the TpBRC appears to be a forum for issues that cross IRS operating divisions' responsibilities, the ACT sees opportunities for state and local employer concerns to flow into the TpBRC for consideration.

It is common for public employers to hear about IRS initiatives via clearinghouse services versus from IRS. It is also common for FSLG staff to hear about program initiatives affecting their customers from their customers. If FSLG headquarters is aware of initiatives, then it is not linking that information to stakeholders via stakeholder communiqués, web site announcements, etc. If unaware, then FSLG should consider reassessing its linkage to initiative efforts, which impact public employers and its downstream communication efforts.

The ability of public employers to influence FSLG activities is severely limited. FSLG has yet to nationally solicit customer input regarding types of guidance and training employers need. FSLG relies primarily on individual FSLG Specialists or upon compliance checks/audits as a basis for determining informational gaps.

Stakeholders were not asked to identify their educational needs before, during or after FSLG reduced outreach/training hours from 75% to less than 25% per year per specialist. State and local employers were concerned with the inadequate and inconsistent training delivered prior to FSLG's seemingly abrupt and unilateral shift to compliance checks/audits. They likewise lacked a communication forum to effectively register either their needs or complaints. Public employers' hope and anticipated confidence in the "new improved IRS" plummeted.

The following examples reflect the lack of participation by public stakeholders.

- In an early fall 2003 meeting, IRS circulated a "vision draft" of the IRS 941, and Employer's Quarterly Federal Tax Return and the complementary Schedule B, Report of Tax Liability for Semiweekly Schedule Depositors, for 2005. IRS relayed this vision document to four stakeholder groups for review: American Payroll Association, the National Payroll Reporting Consortium, National Society of Accountants, and the American Institute of Certified Accounts. No public sector stakeholder groups were asked to participate in either the meeting or the initial review /development of the document even though over 88,000 governmental entities use these documents. Further, IRS expected comments to come back through the four associations attending the November 2003 meeting. Public employers learned of this initiative via their subscriptions to the Bureau of National Affairs, Inc. Daily Tax Report. It was also noteworthy that the FSLG Quarterly Newsletter (December 2003)--issued mid November 2003--failed to mention this initiative.

- Earlier in 2003, a Form W-4 Summit meeting was conducted by W&I Division regarding the Questionable Form W-4 Program. Four stakeholder groups were asked to participate: Compliance and Product Strategy, Baker and McKenzie, American Payroll Association and Federal Liaison Service, Inc. Federation of Tax Administration. Again, private industry was well represented, however federal, state and local governmental employers were not. It remains unclear if TE/GE or FSLG were aware of the summit. It is also unclear if either TE/GE or FSLG were offered an opportunity to participate. The project team found no record that an offer to participate was extended to state or local governmental stakeholders. Likewise, the project team found no record that IRS publicized this initiative to state and local government employers--i.e. neither the FSLG Newsletter nor FSLG web site covered this initiative. Subsequent to the Summit however, a governmental stakeholder group independently sought out the Questionable W-4 Program staff. The stakeholder group illustrated various errors/shortcomings with employer and employee correspondence generated by the program and provided specific, corrective measures. The suggestions were quickly acknowledged and immediately

adopted. The suggestions effectively eliminated misleading business practices and clarified employer and employee responsibilities. The net result removed two compliance barriers.

Lack of knowledge and participation in IRS initiatives by the public sector community undermines the quality and benefits of these initiatives. It creates compliance barriers through exclusion and oversight.

Recommendation: FSLG adopt stakeholder participation in IRS initiatives as a vital program objective; institute an on-going stakeholder work group to review IRS initiatives affecting stakeholders; provide timely feedback and promote information sharing.

Recommendation: FSLG actively monitor inter-divisional initiatives (SB/SE, W & I, and LMSB) affecting FSLG stakeholders and advance stakeholder perspectives to insure end-to-end accountability from "idea to implementation".

- **Customer service levels re employer inquiries and critical program actions such as refund requests are poorly controlled**

Problem: Neither FSLG nor other IRS entities have established timely customer support service standards or adhere to those standards. The project team was unable to find fixed performance standards regarding responses to written or telephoned customer inquiries. A frequent and major state and local government employer complaint was that IRS imposes a myriad of due dates to its clients--especially those affecting timely payment, reporting and responding to mandated IRS inquiries. However, IRS does not impose similar standards on itself. This double standard is a compliance barrier.

- To illustrate, FSLG does not maintain a required turnaround standard for either telephoned or written inquiries. IRM 4.90.2.3 regarding Outreach states, "Generally the FSLG Specialist should respond to a request for outreach assistance within 5 business days. IRM 4.90.2.4.1 states that "the Specialists should normally respond to a request for customer assistance within 5 business days". **These guidelines are not requirements rather they are general parameters that produce uneven service levels and customer dissatisfaction.** Of the feedback respondents, only 42% rated FSLG satisfactory or higher for timely turnaround on issues.

- The IRM likewise did not provide response standards for inquiries for headquarter/OPR/FSLG Director inquiries--telephoned or written. The team noted that many state and local government employers had a mandatory response turnaround for telephone calls of twenty-four hours or one full business day and correspondence within 7 workdays.

- Other IRS requests such as inquiries from service centers regarding potential underpayments or Information Document Requests from the operating divisions were all assigned customer response due dates.

The public employers are highly sensitized to IRS mandated deadlines. It remains a mystery why FSLG and other IRS entities cannot provide comparable service standards when customers request action or respond to an IRS inquiry. At a minimum, customers should be provided business response standards and if the response timeframes are not met, an available recourse to correct that problem. State and local government employers indicated repeated frustration when waiting months for an IRS response--especially when dealing with critical service center issues and private letter rulings.

To illustrate, when an employer underpays an employment tax liability, the clock is running. For a Notice of Penalty Charge, IRS mandates payment in less than 30 days and if not paid within that timeframe, interest is assessed back to the notice date. This process occurs even when there is a strong possibility that IRS and not the employer made the error. For a Proposed Penalty Notice, employers must respond within 45 days from the date of the Notice if in the United States or 60 days if outside the country. However, when refunding tax overpayments, there is no IRS mandated refund issuance standard. IRS policy requires that interest must be paid if the refund is not issued within 45 days. However, that is not a business standard that requires refund issuance within 45 days or less.

Recommendation: FSLG establish tangible customer service standards for both written and telephoned customer inquiries. FSLG should annually measure its customer service performance by applying these standards and publicize the results in the Winter FSLG Newsletter. FSLG advance the need for customer service standards to other IRS entities that provide critical support services to FSLG's customers.

- **Inadequate knowledge by public employers of their IRS service providers**

Problem: FSLG customers remain organizationally naïve in understanding IRS organizational structure. The 1998 IRS Restructuring and Reform Act created direct IRS interfaces with public sector employers and now in 2004, those interfaces still remain elusive. The "new and improved IRS" continues to look like the "old IRS" to many public employers. Unfortunately, recent TE/GE and FSLG accomplishments have yet to reach the public employer community. A typical state and local government employer is unaware that multiple IRS entities can and will interface with that employer. Public employers did not recognize TE/GE nor FSLG or their respective functional roles. Surveyed employers likewise expressed minimal or no experience and/or knowledge of other IRS entities responsible for providing specific services to them.

FSLG must educate state and local government employers about its role and those of other IRS entities. FSLG must advance public employer needs to other IRS divisions whose organizational responsibilities encompass services to public employers but whose primary loyalties and/or priorities do not mirror FSLG's. Creating a "public face" for FSLG and its customers is a complex and critical priority.

Public employers can expect, at a minimum, to be impacted by these additional IRS entities:

1. Service Centers/Campuses--Combined Annual Wage Reporting Program, Questionable W-4 Program, Penalty and Interest Assessments re tax transaction/reporting, refunds;
2. Employee Plans (EP)--Issues regarding retirement benefits and retirement plans
3. Governmental Liaison (GL)--Inter governmental initiatives between governments acting as taxing authorities;
4. Taxpayer Advocate Service--Acts as customer ombudsman;
5. SE/SB Division--handles collection functions and employer functionality tied to programs such as wage levies and burden reduction;
6. Technical Unit-SE/SB--provides specialized tax account services involving large governmental entities and/or entities which were LCI-coded due to prior compliance issues; and
7. Exempt Organizations (EO)--provides determination and examination services for exempt organizations including public institutions of higher education and public hospitals.

State and local government employers expressed concern in not knowing how IRS is structured or the responsibility/ functionality tied to individual IRS organizations. The project team found no products (such as the IRS Roadmap or SERP) which readily educate public employers to their IRS counterparts and their organizational roles. This problem, when coupled with internal/external communication shortfalls between IRS organizations and their public employer customers, creates unnecessary communication barriers.

Recommendation: FSLG "place a face" in its public brochures and via its web site to those IRS entities that interface with public sector employers. The product should identify the players and illuminate a brief description of their respective functionality.

- **Expanding customer services for public employers while minimizing FSLG costs**

Problem: FSLG lacks resources to initiate significant customer services. Strategically, FSLG's co-dependence upon other IRS organizations is a mixed bag. Though many IRS organizations can work autonomously, FSLG cannot. FSLG relies extensively upon other divisions to provide national services that ultimately encompass FSLG customers. As a result, FSLG funding for major customer based initiatives is proportionately smaller as its customer base does not encompass other divisions' customers. If GE generally and FSLG specifically, lack funding to pursue customer initiates, then both must piggyback their needs onto other's developmental efforts.

To illustrate, the IRS Appeals Office created a "fast track settlement program" targeting large corporate accounts. Under the fast track settlement, a specially trained appeals officer facilitates discussion between the taxpayer and the examination team when a

contentious issue(s) arises while an audit is active. In November 2003, Appeals and SB/SE announced that Appeals was creating a similar program for small business taxpayers. These efforts are tied to reducing the lengthy appeals process. As of early 2004, GE and FSLG had yet to partner with Appeals to secure this program for public employers even though these employers would welcome a less lengthy and aggravating appeal process.

In mid 2003, the SB/SE Division began development of a video lecture entitled "Federal/State Payroll Tax Workshop CD ROM". This project was a cooperative effort with SSA, Department of Labor, and state tax agencies affiliated with the Federation of Tax Administrators. Product rollout in 2004 will primarily assist new employers (within SB/SE's purview) in understanding and meeting their employment tax obligations. One entity (Indian Tribal Governments) of Governmental Entities partnered in this endeavor, FSLG did not. Unfortunately, in not doing so, FSLG missed an opportunity to utilize SB/SE's resources to the direct benefit of FSLG's customers. With minimal front-end involvement, the video workshop could have been viable for public employers and an excellent FSLG voluntary compliance introductory tool. FSLG can still capitalize on SB/SE's efforts and minimize its cost by adapting the final CD-ROM to reflect a public employer setting.

These are just two examples where FSLG can create opportunities without necessarily incurring full or significant development costs. Given its limited funding, "creating and/or recreating the wheel" are not solid business strategies. FSLG must be opportunistic in using dependent relationships to FSLG and its customers' advantage. In doing so, FSLG should also apprise its staff and stakeholders of each successful result.

A prime opportunity which FSLG should pursue centers on SB/SE's Form 941, 941c and refund processes. State and local government employers expressed strong dissatisfaction with Form 941/941c report processing and refund operations. The Ogden Service Center noted for public employers on the Industry Issue Code Tracker Report for October 2003 through September 2004 that the two highest volume issues (out of 22 issue types tracked) were Form 941/941c and refunds. A common compliance barrier cited by public employers was service centers losing or misplacing Form 941 and 941c documents and requiring employers to submit duplicates. As noted previously, state and local government employers cited the refund process as inadequate, confusing, slow, etc--a serious and costly barrier. These problems are national in scope and reoccurring--it appears to be a systemic dysfunctionality. FSLG should enlist SB/SE to review and implement corrective measures on behalf of FSLG's customers.

By drawing from other IRS divisions' initiatives, operational roles and customer based services, FSLG can maximize benefits derived while minimizing resource demands. This likewise holds true for user involvement. When initiatives arise that benefit public employers, FSLG should cultivate their participation on other divisions' work groups. Encourage stakeholders to perform program support in lieu of FSLG resources--eliminate unnecessary buffers between stakeholders and other divisions.

Recommendation: FSLG adopt an opportunistic customer initiative strategy which "piggybacks" FSLG customer needs on other IRS divisional initiatives and eliminates sole reliance upon FSLG to represent customer needs. FSLG should begin implementing this strategy starting with the Form 941/941c and refund issues.

Dismantle compliance barriers through identification of barriers

The following barriers were identified through the national feedback/survey processes. The issues encompass IRS/Treasury practices and represent real barriers to voluntary compliance as experienced and expressed by state and local government employers and IRS staff directly supporting those customers. They are legitimate opportunities for federal tax authorities to promote and achieve greater voluntary compliance by rethinking and revamping business practices.

- **Automate Web site employer subscription(s)**

Problem: Employer subscriptions to IRS on-line information services and use of those services are inadequate. The educational value and power of IRS web site use are diminished sans routine and regular employer use.

New employer tax accounts are established every workday. At least some of these employers undoubtedly fail to consider the scope of their tax informational needs. Nor do they take time to search out this information. These employers are too consumed with establishing a business function or governmental organization. However, these employers generally know that they must collect and report taxes and to do so, secure an Employer Identification Number (EIN).

Recommendation: IRS expand the Form SS-4 (Application for Employer Identification Number) process to collect every new employer's e-mail address. The form identifies and IRS categorizes the employer as an SB/SE, W&I, LMSB or TE/GE customer. With those two pieces of data, IRS can automatically subscribe a new employer to the appropriate IRS website(s). This service eliminates employers from hunting for the appropriate site(s) and enables IRS to automatically push down new information to employers as it occurs. Any employer not wanting to maintain a subscription(s) could unilaterally cancel the subscription(s).

Note: A similar concept was implemented in January 2004 regarding federal EIN applicants being automatically registered for electronic tax deposits. When filed on-line by TeleTIN, applicants that were expected to have a federal tax obligation were automatically pre-enrolled in the Electronic Federal Tax Payment Systems (EFTPS).

- **Inability to release annual tax information timely (well prior to the start of new tax year) wherein employers can prospectively implement new requirements**

Problem: State and local government employers cannot apply new tax rates, benefit thresholds, valuation factors, etc. to properly withhold, report and remit taxes effective January 1 if this information is not provided well prior to January 1. The late release of essential tax data creates expensive retroactive corrective actions and untimely tax payments. Many governmental entities use very old legacy systems, which require labor intensive reprogramming for any change. These changes are often very time consuming and especially costly (particularly when done on a rush basis at year-end which forces holiday and overtime pay expenditures).

For example, for tax year 2003, the maximum automobile value used to determine if the "vehicle cents per mile rule" applies was not released before 2003 began. In fact, Publication 15-B stated that the information would be published in a revenue procedure in the Internal Revenue Bulletin in early 2003. The information was **not** subsequently released via any normal venue. Note: this same language appeared in the 2004 Pub 15-B.

Not only was this information not released before the start of the tax year, IRS did not provide employers any **interim guidance** until three months into the 2003 calendar year. Guidance only occurred at that time due to stakeholder requests for interim direction and safe-harbor relief for using that direction. Employers could not be compliant, through no fault of their own. Likewise, employers faced expensive retroactive processing for incorrectly projecting a 2003 rate and then later, correcting these projections. IRS' communication failure to provide timely interim direction needlessly jeopardized voluntary compliance and created additional administrative employer burdens.

FSLG was unaware that this information was not available until questioned by its customers. FSLG then proceeded to intercede with the IRS attorney responsible for drafting the Revenue Procedure containing the 2003 rate. Informally, FSLG was successful in getting authorization for employers to temporarily use the 2002 rate of $15,200. Again, this action **only** occurred after the employer community raised the issue and requested interim direction. The 2003 problem was duplicated in 2004--this information was released in Rev. Proc. 2004-20 dated March 29, 2004. Rev Proc 2004-20's late release prompted Commerce Clearing House Incorporated (CCH) to note on April 8, 2004, "Beating last year's timetable by over six months, the IRS has just released it annual luxury auto cap figures". State and local government employers remain perplexed that values/rates that are effective each and every January 1st are not made available well before that date.

A second example involves the definition of a control employee when using the commute valuation method to value the personal use of an employer provided vehicle. Section 1.61-21(f) of the Regulations provides that a control employee may not utilize the commuting valuation method and defines such employee as an elected official or a government employee whose compensation is equal to or exceeds Federal Government Executive Level V. The Office of Personnel Management publishes this

compensation information. It is not generally available to employers until after the start of a new calendar year, again placing employers into retroactive employment tax application. In 2003 for example, Publication 15-B did not contain this data and referred customers to a web site for 2003 compensation information.

No single IRS entity is responsible for insuring that employers have all required employment tax information. No single IRS entity is responsible for telling employers that such information will not be provided/provided timely. Nor is there an IRS standard or policy that mandates that required annual tax information is provided well prior--a minimum two months--to the start of a new tax year. This timeframe permits employers to test and implement system changes prospectively and without significant costly retroactivity. There is no policy that requires IRS to provide interim direction pending receipt of delayed information. Absent these fundamental controls, state and local government employers cannot timely fulfill their tax responsibilities. By not managing the annual tax information stream, IRS creates another substantial compliance barrier.

Recommendation: IRS establish a central entity to track the timely release of annual tax information, including non-IRS parties which annually provide tax data, within an annual cycle which insures prospective tax implementation.

Recommendation: IRS adopt as a servicewide policy to immediately provide timely interim direction whenever release of annual tax data is unavoidably delayed and provide a corresponding safe harbor (and reliance) for employers using this interim direction.

- **Inadequate advance notice of implementation of new IRS processes**

Problem: IRS routinely fails to provide advanced publication of implementation schedules for either new operational business practices or what changes state and local government employers will experience. Only 63.1% of the respondents rated IRS notification/lead time for implementation programs and system changes as satisfactory or higher.

For example, IRS announced and implemented a revised Electronic Federal Tax Payment System (EFTPS) on July 21, 2003. Many state and local government employers learned of the implementation when they attempted to process tax payments on July 21, 2003. Although the changes to EFTPS were reasonably manageable, the IRS should not perform conversion activities without sufficient, advanced notice of the implementation date. Nor should employers face conversion activities and generate tax payments via trial and error. Employers must be afforded ample opportunity to know the changes and test their systems prior to using "live" data.

A second example was the new e-file System Framework that was implemented beginning 2004. In November 2003, IRS announced that participants in the Employment Tax e-File System on or before October 15, 2003 were required to reregister so that all required information would be housed on IRS's new database.

Participants were required to re-register by November 17, 2003. This requirement was due to a redesign of the e-File application process, which consolidated business Form 9041 and individual Form 8633 into a single process. Effective October 15, 2003, the Form 9041 became obsolete.

Not only was this timing inadequate, Form 8633 had requirements that were unacceptable in the public employer sector environment. These requirements included the Reporting Agent's home address, SSN, date of birth and fingerprints. It also stated that a credit check would be run on the Reporting Agent. These requirements might be appropriate for private sector employers/reporting agents, however, they were immediately questioned by at least one public sector stakeholder group, NASACT. NASACT identified these barriers to IRS and by December 9, 2003, FSLG officials confirmed that the e-File System did not require a credit check nor fingerprint card file for state and local government employers.

By failing to work with stakeholders, the timing and requirements tied to the Form 8633 process were fraught with barriers. The December 9, 2003 release of clarifying instructions for governmental employers readily pointed out informational deficiencies that likewise created employer confusion. For example, Line 3 on Form 8633 states "If you are a Not for Profit service, check the one box that applies--5 boxes are identified with one being titled "Employee Member Benefit". In the clarifying instructions, employers were told to check the Employee Member Benefit box for "routine payroll function". No public employer would intuitively associate payroll functionality as being "Employee Member Benefit". Further, Form 8633 completion instructions do not define Item three terms such as "Employee Member Benefit". Rather, the instructions state, "Check the box that applies". In the state and local government employer's environment, pay and benefits are generally two distinct service areas.

The e-File program's hastened timetable and lack of adequate stakeholder review prior to release of the Form 8633 and submission timetable adversely impacted employers and IRS's program conversion.

Other federal agencies such as the SSA are extremely active and effective when transitioning from one operational system or product to a new one. SSA's conversion to Magnetic Media Reporting and Electronic Filing or MMREF systems was underscored by extensive advanced dialogue, marketing outreach and stakeholder forums. SSA's success is largely due to the agency viewing and anticipating employer issues and needs well prior to implementation. SSA does not "spring" business practice evolution upon its customers, rather it works prospectively with its customer base to insure compliance and conformity. The results justify the front-end customer investment.

Recommendation: IRS review and adjust its communication systems to insure that stakeholders receive adequate advance notification of operational changes, including impacts employers will experience when implementing those changes.

- **Publications lack sufficient information and examples illustrating tax application for state and local government employers to properly execute their tax and withholding roles**

Problem: Employers indicated that they subscribe to national payroll/clearinghouse services to augment IRS publications. These services are designed specifically to sell products, which enable employers to execute employment tax roles. The products are typically written in user friendly language and provide an array of examples to illustrate regular administrative issues that arise from taxable and reportable pay and benefits. Many public employers viewed these subscription expenses as "forced costs".

These costs occur because IRS does not provide employers with comprehensive tools via its publications to accomplish the tax mission. Public employers likewise want to proactively mitigate audit liabilities and minimize compliance costs. Employers fear IRS repercussions from "guessing how to follow general versus objective tax requirements". Over 40% of all large governmental entities/respondents subscribed to payroll/clearinghouse services. Correspondingly, those respondents not subscribing to these services were predominately small governmental employers--special districts, cities or counties with fewer than 100 employees.

State and local government employers also lack confidence in IRS staff to equitably apply "facts and circumstances". It remains a common business reality that public employers ask the same question to various IRS entities (Call Center, Specialist, etc.) and often answers are different. The result encourages "shopping around" for a favorable answer as well as apprehension in applying these answers.

As noted elsewhere in this report, the absence of objective and readily applicable tax standards/criteria is a long-standing IRS (and/or Congressional) generated compliance barrier. State and local government employers just want to know the requirements timely and implement them accordingly. Unfortunately, some IRS publications and guidance affecting FSLG customers fall significantly short of these marks. Publications often are merely guides whose information does not extend beyond information released in IRS rulings. The formal rulings are often highly technical and narrowly scoped which may not address the practical application of those rulings.

Unfortunately, therein resides the problem. When informational deficiencies exist and publications are irrelevant, the recourses available to public employers include: contracting for a payroll service, hiring a staff of tax attorneys to decipher the Internal Revenue Codes and hope they are correct, or take a best guess and implement what makes sense. For many public employers, options one and two are cost prohibitive.

The following illustrates a few of a single publication's shortcomings--Publication 15-B Employer's Tax Guide to Fringe Benefits--and why those shortcomings represent compliance barriers. Pub 15-B is the primary IRS reference source available to employers regarding fringe benefit tax administration. Employers noted Pub 15-B

lacked information and instructional aids, which produced downstream tax withholding and reporting deficiencies.

Publication 15-B identifies a fringe benefit "as a form of pay for the performance of services". It also states that "a person who performs services does not have to be your employee. A person may perform services for you as an independent contractor, partner, or director". It then adds "treat a person who agrees not to perform services (such as under a covenant not to compete) as performing services". State and local government employers do not relate or understand what that definition means or requires--these employers typically deal in employer/employee relations. Publication 15-B further muddies the water by switching back and forth between employee versus a person performing services. The overview of De Minimis (Minimal) Benefits provides a suspect definition of employee versus staying with person performing services. It states, "**Employee**. For this exclusion, treat any recipient of a de minimis benefit as an employee". Most employers do not translate this definition to encompass independent contractors, non-paid volunteers, public officials, directors of employer, etc. However, those entities are within that scope and employers are responsible for insuring appropriate treatment under that requirement.

Publication 15-B fails, as does the corresponding Income Tax Regulation Section 1.62-21(f), to define basic terms or criteria, which affect whether or not an employer may use an alternative valuation method. The regulation and publication state that all requirements outlined must be satisfied to utilize the commute valuation method. One requirement is that the employee must commute to and from work in a vehicle for bona fide non-compensatory reasons. Bona fide non-compensatory reasons are never defined. State and local employers cannot apply a requirement without knowing what the requirement entails.

Publication 15-B provides rules and regulatory requirements. Unlike some excellent IRS training materials such as FSLG's Fringe Benefit Training, which covers a subject and then provides 3 to 4 examples, Publication 15-B is nearly example free. The absence of clarifying examples diminishes the value of the publication. Many employers lack the tax savvy to effectively read between the lines. Likewise, these same employers may lack funds to purchase tax services, which decipher IRS requirements, regulations and publications and identify their impression of IRS administrative applications. IRS Publications which deliver requirements but fail to demonstrate real world application do not serve their audience.

Recommendation: IRS re-evaluate its publication program to insure the program:

- Empowers state and local government employers to properly execute tax responsibilities without subscribing to ancillary informational services;
- Provides an efficient and timely update process, which bypasses unnecessary IRS reviews/delays prior to publication;
- Encompasses formal governmental employer stakeholder and interdivisional/IRS organizational ownership of employer based publications; and

- Requires all publications affected by new rulings to reflect any new requirements stemming from those rulings.

- **Inadequate identification/information regarding IRS generated correspondence**

Problem: IRS correspondence fails to adequately identify the source of those generating correspondence in a manner useful and educational to employers. This barrier is a cross cutting issue applicable to all IRS entities and one that impacts many IRS stakeholders.

Public employers are required to interface with well over a dozen IRS organizations as a direct result of TE/GE and FSLG's dependence upon these organizations for technical services. State and local government employers routinely do not know which IRS organization is providing correspondence. Employers do not understand that entity's role and responsibility within the employment tax arena.

The following represent random examples supplied by employers, which illustrate inadequate identification/information.

- Lock-In letters generated by the Questionable W-4 Program do not identify the IRS division responsible for this national program. State and local government employers have no basis to think that anyone handled this program other than TE/GE and FSLG. Letters from the Service Campuses reflect they are from the IRS and a specific site (city) along with a unit name, such as Code and Entity Unit. Any employer that is unfamiliar with the campus functionality (many are), would not know that Code and Entity was part of the SB/SE and not TE/GE.

- IRS Letter 1995 (DO) (Rev.7-1995) Catalog Number 62794I, a general correspondence form letter, provides an IRS contact name, phone number, Employee Identification Number and tax year ended number. There is no identification of a given IRS unit or division responsible for that correspondence. The standard Information Document Request (IDR) 004-0004 likewise provides a contact name, telephone number, EIN number and a tax period. The form does indicate that the letter stems from TE/GE Division. However, it does not indicate which unit, in this case FSLG, which originated the correspondence. Governmental employers such as public colleges and universities would not know whether Exempt Organizations (EO) or FSLG generated the correspondence.

- FSLG Specialists acknowledged that they too were unfamiliar with the other IRS division's structures and functionality. Specialists cannot readily assist public employers to "find" the right IRS contacts if they do not know where to look. Specialists indicated concern that functional and organizational clarity was lacking and impeded their ability to assist employers. The absence of standard identification re normal communication mediums negates conducting business timely and effectively. It was unclear if FSLG specialists had received training on

the use of the IRS Roadmap released July 2003 or the Servicewide Electronic Research Program (SERP). The Roadmap is a website directory that locates primary management officials in all IRS business units and geographical areas. SERP provides IRS employees with a multitude of contact information for various IRS programs.

- A second flaw with IRS correspondence was the failure to identify the basis for correspondence in a meaningful way to the recipients. Computer generated IRS correspondence provides a significant amount of information important to internal IRS controls. However, the correspondence fails to provide a "subject description" or provides inadequate and oblique descriptions. The same problem exists with other routine IRS correspondence such as Compliance Check Opening and Closing Letters--refer to IRM 4.90.2.3.

- For example, a typical computer generated IRS letter states "Thank-you for your inquiry of mm/date/yr". This opening fails to distinguish the letter's subject matter or even the intended addressee. IRS also uses this same opening on letters wherein an employer never made an inquiry but rather, provided documents such as Form 941 or Schedule B per IRS' request. These types of unclear and inaccurate basic communication are barriers.

- Employers, especially those possessing multiple EINS, noted that insufficient addressee information and subject matter identification made it nearly impossible to redirect correspondence to the proper recipient. Correspondence addressing a prior inquiry where no inquiry occurred generated unnecessary data searches. As a result, correspondence was either returned to IRS or "placed aside" with the idea that IRS would initiate another contact sometime "down the road".

Recommendation: IRS adopt as a servicewide standard that all correspondence identify the appropriate operating division name (or highest organizational nomenclature) as well as the specific sub-organization of the division generating correspondence. For example, a letter from the Ogden campus should indicate that the letter is from Small Business/Self Employed Division along with the specific unit generating the letter--i.e. Code and Entity Unit 3, Ogden Service Center.

Recommendation: IRS adopt as a servicewide standard that all correspondence provide a "subject description" that identifies the basis for the communiqué, which meets the "common person" test. Correspondence must contain a concise statement outlining why an addressee is being contacted--a statement that any common person would readily understand. For example, if the Code and Entity Unit was contacting an employer regarding an address change assigned an Employer Identification Number (EIN), that Unit would include a subject line indicating: Confirmation of Employer Address Change for EIN xx-xxx-xxxx.

- **Inadequate identification/information regarding IRS generated refunds**

Problem: IRS refund checks generated by SB/SE lack sufficient information for employers to clearly identify the basis of the refund. This too represents a cross cutting IRS organizational barrier. Refunds can be issued for various reasons including overpayment of taxes, interest, penalties and additions to tax. The absence of clear identification tied to a refund creates undue hardships for employers. This is especially true for public employers who share "the employer" role with multiple internal entities. States, large cities or county governments may have multiple entities using the same EIN for refund purposes that are unique to each entity.

Refund checks for employment taxes reflect an EIN, the Form generating a refund (F-941 Ref) and a tax quarter date (i.e.09/99). The checks reflect a single figure for interest with no corresponding information. Refund checks for other reporting such as 1099 likewise reflect other references such as CVLPEN, and an EIN with a quarter date. The check likewise provides an interest amount if applicable with no corresponding information.

IRS Notice 134 normally accompanies the refund check. The Notice states, "the amount of the enclosed refund check may be different from the amount you were expecting. If you haven't already received our separate notice explaining why, you should receive it soon". It goes on to say, "If you think we may have made an error, please call us or send a letter describing it. If you are certain the refund check is too large, please return the check with your letter and we will send you the correct amount. If the refund is too large and you don't return the check, you may owe us interest". This Notice acknowledges that employers may have no idea what the refund represents nor the basis for the amount.

The absence of information on the refund checks generates additional employer burdens and IRS resource expenditure. For example, if an employer files different refund requests for the same tax quarter, accounting for refunds paid and those pending cannot necessarily be tracked solely by amounts. Depending on the organizational structure of a governmental entity, more than one entity can be responsible for filing and processing refunds; they may use the same EIN.

Employers likewise do not know that the interest being paid is correct--there is no information indicating when interest payments began or how many days the interest payment represents. If the refund amount is different from what the employer requested, the employer must expend considerable resources to determine what it is for and whether it is correct. The accuracy of the refund amount and the explanation for that amount should be provided with the refund.

Recommendation: IRS assign a basic tracking code (date request is received) or indicator (description on the refund) that readily ties a state or local government employer's specific refund request to the corresponding issued refund check. Provide

an explanation regarding the refund amount including the interest computation--a formula, number of days interest was paid, or inclusive dates the interest represents.

Problem: The IRS refund process is not customer friendly. For example, employers complain that the Philadelphia Campus "unilaterally" refunds employee FICA taxes and notifies employers to correct their records without contacting the employer first and allowing them to research a claim. In many cases according to employers' records, impacted employees (such as non-resident aliens) were not entitled to a refund. That in turn creates an imbalance between Form 941 and Form W-2 reporting plus creates uncertainty if the employer should then likewise seek a refund for employer share of SS/MED taxes.

This problem is further compounded as state and local government employers may have multiple refund requests pending and IRS does not apply a turnaround refund standard. IRS pays interest if a refund is not issued within 45 days. However, few if any employers can effectively "remember" how many outstanding refunds exist or the specific amount of those refunds as they relate to a specific issue.

Another frequently cited compliant was the automatic allocation of credits to other tax liabilities without adequate communication with employers. This process not only makes employer reconciliation nearly impossible, it creates crossover issues when a government unit for one tax receives credit for another government unit's tax responsibility. Crediting taxes under the current method might work well for IRS, however, it creates barriers for public employers.

Recommendation: IRS review its refund production cycle and initiate corrective measures to address communication shortfalls and implement a refund standard that returns state and local government employer funds with the same time sensitivity as IRS requires regarding underpayments and penalties.

Recommendation: TE/GE, using its various newsletters, publicize IRS corrective measures and customer service tax refund standards.

- **Inadequate controls to an employer's Business Master file account**

Problem: The Business Master file controls are inadequate with respect to address changes. Unlike name changes, which require written confirmation prior to making a change, address changes occur without adequate validation. IRM 4.19.3.20.1.4 outlines standards for updating address changes including that a "return (including an amended return) filed by a taxpayer with new address information is considered" sufficient notification.

Unfortunately this process fails to neither recognize nor control address changes with large and diverse public sector employers in mind. These employers often have shared employment tax responsibilities and larger governmental employers, such as states and large cities/counties, routinely have one or multiple EINs assigned to different entities

for unique programs administered by the State, city or county. Though the EIN may be shared or separate, the individual addresses for these separate entities with different reporting responsibilities are unique.

For example, a state may use one EIN for reporting employment taxes through a central department or each state department may be assigned their own EIN. This practice may occur for Form 1099 reporting, as well as other reporting such as excise taxes, values tied to stored alcoholic products, heavy highway vehicle use, etc.

Under the current process, various IRS staff can initiate changes to an employer's EIN account by inputting to the Code and Entity Unit at the Service Center. It can also be erroneously and inadvertently changed by a governmental entity filing a return for one type of business activity with a different address than say a governmental entity reporting employment taxes.

The filing entity can check an address change box and provide a new address because the address preprinted on the return reflects the second entity's address. The second entity's address appears because it was the address of record on the Business Master file. When the new return is processed, the new address is entered. Immediately, any IRS notices, returns, correspondence are directed to the new Master file address. The recipients, who do not work with these materials, either "toss them" or return them to IRS.

Unlike an "account name change" which requires a letter sent to the filer to verify the change, address changes do not require validation (i.e. articles of incorporation). The effects of this problem are far-reaching and costly to public employers. Failure to receive communiqués and mandatory quarterly returns pose immediate financial liabilities to public employers. Also, due to the disclosure rules, an employer cannot readily isolate the party changing an address by working with the service center. The problem is recurring and each corrective action spans months. This problem is likewise the basis for public employer concern regarding a possible IRS E-file capability of online address changes.

Recommendation: IRS review the Business Master File address change process as to state and local governments and implement safeguards to preempt erroneous address changes plaguing public employers.

Recommendation: IRS implement an expedited corrective process that rectifies inadvertent Business Master File errors on state and local governments within five workdays and provides an electronic media/outreach training program for state and local government employers addressing this business problem.

- **Absence of regulations which provide objective and clear requirements**

Problem: IRS issues guidance via revenue procedures and regulations that lack objective standards, which support full and independent compliance via employer

administration**.** Although state and local government employers positively attempt to improve regulations prior to their release via comment periods, administratively workable regulations remain the exception and not the norm. Further, when business practices reinforce the suspect nature of outdated regulations, IRS is slow to react.

Regulations for De Minimis Fringe Benefits underscore both barriers. IRC 132(e) states that a De Minimis fringe benefit is property or service provided by an employer for an employee that has a small value and accounting for it is unreasonable or administratively impractical. The value of the benefit is determined by the frequency provided to each employee or if this is not administratively feasible, by the frequency provided to the whole workforce. By definition, this benefit is open to and in fact has, been interpreted widely with extreme results. Throughout the years, IRS has ruled time and again as to specific items/frequency that met/fail the de minimis concept. IRS has given advice for example in ILM 200108042 that a benefit of $100 did not qualify as de minimis. Payroll organizations state in their training seminars that although there is no fixed amount, employers can use very liberal values--exceeding $100. Clearly, these approaches do not advance tax compliance nor tax equity. They do however, advance discourse and an uneven playing field wherein opinion and not standards, are the focus.

State and local government employers routinely seek concrete definitions of what the de minimis terms of unreasonable, administratively impractical, small value, etc. mean in real world terms. Employers asked IRS to set a de minimis value wherein items under that ceiling qualify for exemption. IRS steadfastly refuses to set a monetary standard and instead, forces both employers and IRS staff to constantly spar over "facts and circumstances". The de minimis exemption represents a small revenue source, which receives a disproportionate amount of attention. IRS can eliminate significant employer anxiety and administrative complexity by ending an arbitrary and subjective standard. Employers may not agree with the ultimate objective standard, however, it is preferred to subjective standards because it is administratively workable and it provides 100% compliance confidence.

We suggest IRS look to a parallel analogy, the elimination of the receipt requirement for 100% of all travel expenses, to underscore what is possible with de minimis and related subjective requirements. Clear, concise, objective and administratively compatible requirements advance employer compliance. IRS previously required a receipt for 100% of all travel expenses. Based on strong and repetitive customer lobbying, IRS implemented a $25 or more threshold for most travel based expenses. Expenses under $25 dollars and sans lodging no longer require a corresponding receipt to satisfy documentation requirements. This standard was operational until September 30, 1995; IRS raised the threshold to $75 effective October 1, 1995.

This shift in rule making not only reduced employer costs, it made compliance easier without creating a loss in revenue streams. It was an intelligent business decision, which recognized that "doing business as usual" was not viable. It affirmed that compliance could be advanced without sacrificing program controls. Applying an

objective standard enabled employers to administratively comply, but unlike de minimis benefits, they could also readily articulate this standard to employees.

Recommendation: FSLG in conjunction with stakeholder participation, identify five tax regulations whose subjective requirements (such as de minimis fringe benefits) represent the most frequent compliance barriers to the stakeholders. Working through the other IRS divisions and Chief Counsel, recommend projects via the IRS Priority Guidance Plan to address and replace subjective standards (to the extent possible), with objective standards that promote independent tax compliance.

Adopt the concept of voluntary compliance through barrier elimination as a strategic focus for customer services and regulatory actions.

Voluntary compliance can be highly successful when approached as an IRS activity explored through cooperative efforts with its stakeholders. It requires IRS to recognize first that barrier elimination and tax fairness must originate within the Service as a strategic focus for tax administration. The Service must "value" voluntary compliance and capitalize upon the integrity of state and local government employers. IRS should recognize that old compliance models reinforce and perpetuate questionable business practices--in many cases, those practices impede equitable tax administration.

Prospective, voluntary compliance is not a strategic focus

Problem: Throughout its history, IRS has relied upon audits as its primary compliance strategy and means to assure tax fairness. This strategy was supported by a myriad of tools including those that punished noncompliance. IRS remains reasonably sophisticated in creating audits and assessing a plus or minus revenue stream generated by audits. As reflected in recent FSLG efforts, IRS is substantially less sophisticated in measuring the success of its outreach and educational compliance based programs and in achieving tax fairness.

IRS has yet to establish effective measurements of programs or their ability to promote independent, voluntary compliance. There is no accurate means today to compare the effectiveness of post employment tax audits to that of compliance achieved via empowerment of educated state and local government entities. Due to this inadequacy, compliance is perpetuated and driven by the "audit/then educate" model.

The "audit/then educate" model presumes that the tools, knowledges and capabilities pre-exist and if just used, produce compliant behavior. The theorem also presumes an employer is likely to be non-compliant--at least until the audit results demonstrate otherwise. Once non-compliant behavior is identified, the Service initiates corrective measures including training. **The theorem does not address the adequacy or inadequacy of employers to prospectively comply based upon the tools and information provided**. The "audit/then educate" model remains seriously flawed and

represents a costly and reactive versus proactive means to achieve compliance in the area of FSLG customers.

Recommendation: Servicewide, IRS "value" its state and local government stakeholders' perspectives regarding compliance barriers and use barrier removal as a strategic focus for advancing voluntary compliance and customer services.

- **Uneven application of compliance measures exists between federal employers and all other state and local government employers**.

Federal employers, though liable for paying employment taxes under the same regulations as private/state/local government employers, are not subject to the same corrective actions for non-compliant performance. The project team recognizes that Congress and Treasury must address this problem. However, we note that a legislative change on this point would be the way to achieve parity between the federal employers and state and local employers.

A 1978 Comptroller General of the United States opinion (B-161457) states that as an employer, the Government of the United States, its agencies and instrumentalities were subject to various IRC requirements including withholding of employment taxes via 3402(a), 3404, 3102, and 3122. The opinion noted that the IRC provisions requiring the payment of interest and penalties, IRC sections 6601, 6656, 6659, 6671, are general provisions applicable to all taxes under the IRC. However, the opinion concluded, "The rationale for applying these provisions against the private sector employer is not present when the employer is the United States since the funds are already in the hands of the United States".

The Comptroller General supports this determination by a simple litmus test, "The United States as an employer is liable for the payment of salaries and employment taxes in the same manner as the private sector employer. However, these payments come from the appropriated funds of the particular Federal agency or instrumentality employer, which are available only for the purposes for which they are appropriated. As such, these funds would not be available for the payment of interest and penalties pursuant to the above stated rule". The opinion closes by saying, "that even though Federal agencies may not use their appropriations for payment and penalties, it is our view that such agencies are required to meet the statutory filing deadline and should take all necessary steps to insure compliance deadlines".

State and local public employers viewed this administrative distinction and uneven application of compliance remedies as unfair and discriminatory. State and local governmental employers see no tax distinction between themselves and their federal counterparts. Like federal agencies, the payment of salaries and employment taxes come from appropriated funds which are only available for the purposes by which their legislative or executive branches of government appropriate and authorize. The project team could not identify a state or local governmental employer who routinely budgeted or appropriated funds specifically to pay IRS levied penalties and interest. Further,

through various federal "pass through" or "pass down" funding programs, state and local governments are using federally appropriated funds to directly pay employee salaries for mandated federal programs.

Unlike its private sector counterparts and mirroring its federal peers, state and local governmental employers are not profit driven entities. There is no public service motive to sanction state or local noncompliance. Quite the contrary, the combination of checks and balances including public and political accountability demand compliance. Neither state nor local jurisdictions can print money to cover IRS levied penalties and interest. These entities cannot unilaterally increase taxes or fees to pay these assessments. They can however, be forced to terminate operations and cease existence if compelled to pay penalties and interest for which there are no appropriations. These results bring a sharp focus to the separation of state and federal powers, due process and the equity of federal tax administration.

FSLG likewise faces a difficult compliance challenge with federal employers. If the assessment and payment of assessed penalties and interest are not available tools, how does IRS secure compliant, federal behavior? The team found no documentation answering this question. The team did note (GAO-04-74) that IRS escalated attention to this issue while attempting to correct long-standing, non-reporting of Form 1099 data by federal agencies. The Commissioner stated that IRS Policy Statement P-2-4 (based on the GAO Comptroller General Decision B161457) provides that federal agencies are not subject to penalties. The Commissioner noted that if an agency does not wish or is unable to comply with its Form 1099 MISC reporting responsibilities, there is nothing that IRS can do but rely on voluntary compliance on the part of the agency. GAO-04-74 recommendations did not address the Commissioner's concerns regarding General Decision B161457.

Recommendation: Federal, state and local governments should have identical compliance remedies consistent with the IRS mission "to apply tax law with integrity and fairness to all".

Conclusion

This report represents the third in a series of ACT reports addressing TE/GE and FSLG's organizational and functional development. The underlying review was tied to a single concept--what, if any opportunities exist for FSLG and other IRS/Treasury entities to advance voluntary public sector employer compliance as expressed by state and local government employers.

As a result, this document provides a snapshot of state and local government employer views on the current employment tax environment. It identifies tax compliance barriers recognized by state and local government employers across the nation as well as from IRS entities supporting this market segment. The issues, problems and resulting recommendations provide an informational platform for IRS entities including FSLG to re-examine, re-engineer and re-energize IRS business practices in this environment. Although several recommendations crossover into other IRS and Treasury entities, this report provides FSLG with information to advocate its customer's needs, advance services and promote voluntary tax compliance.

FSLG and other IRS entities with state and local government employers can create mutually beneficial relationships that produce exponentially growing voluntary compliance powered by the elimination of tax compliance barriers. Sustained and viable relationships mandate that all parties "value" voluntary compliance. Each must work hand in hand to remove policy, procedural, structural and other communication shortcomings plaguing employment tax administration today.

EXHIBIT A

EMPLOYER SURVEY INFORMATION

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY SAMPLE

PROGRAM PERFORMANCE

1. Please indicate your level of satisfaction with the IRS in the following areas (mark "no experience" if you have not dealt with an item):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Meeting your tax information needs timely					
Meeting your tax information needs accurately					
Providing training services					
Delivering customer service					
Processing private letter requests--turnaround time/cost					
Providing lead time to implement program and system changes (i.e. W-2 changes, withholding rates, etc)					
Understanding your employer environment					
Providing reliable technical assistance					
Processing employer Form 941, 941c, 843, tax payments and tax refunds					
Performing compliance checks, reviews and audits					
Working with other federal entities (i.e. Social Security Administration, etc.) to solve employer issues					

CUSTOMER SUPPORT

2. Please indicate your level of satisfaction with your Federal, State, Local Government Specialist (FSLG) in the following areas (mark "no experience" if you have not dealt with the Specialist on an item):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Available for assistance by phone, fax, electronic mail, or in person					
Understand your governmental organization's structure					
Know other IRS functions, services and structures					
Deliver appropriate technical training					
Partner to remove compliance barriers					
Satisfy public employer information needs					
Provide timely turnaround on issues					
Conduct compliance checks, review and audits					

COMMUNIQUES

3. Please indicate your level of satisfaction with IRS on-line products used to meet your employer information needs (mark "no experience" if you do not know the product).

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Digital Dispatch					
e-News					
IRS Newswire					
IRS Tax Tips					
Employee Plan News					
Tax Stats Dispatch					

FSLG Newsletter					
Quick Alerts					

EXHIBIT A

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY SAMPLE (CONT.)

COMMUNICATION

4. Please indicate your level of satisfaction with the following used to meet your "employer" information needs (mark "no experience" if you have not used a product or worked with a listed entity):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
IRS Web Site					
FSLG Web Site					
Ogden Service Center					
Government Liaison					
IRS Publications: Pub 15 Employer's Guide					
Pub 15a Employer's Supplemental Tax Guide					
Pub 15b Employer's Tax Guide to Fringe Benefits					
Pub 463 Travel, Entertainment, Gift & Car Expenses					
Pub 508 Tax Benefits for Work Related Education					
Pub 535 Business Expenses					
Pub 963 Federal-State Reference Guide					
Office of Chief Counsel					
FSLG --Area Groups/Specialists and Outreach, Planning/Review staffs					
Taxpayer Advocate Service Office					
Customer Account Services					
Wage and Investment					
Subscriptions to Tax and Payroll Informational Services					

PROGRAM ADMINISTRATION

5. Please indicate your level of satisfaction with IRS administration for the following programs (mark "no experience" if you have not dealt with a listed item):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Collections					
Informational Reporting (W-2)					
Informational Reporting (1099)					
Federal Filing Requirements (941, 941c, etc.)					
Electronic Fund Transfer Tax Payment System (EFTPS)					
Form W-4 "Lock-In Letter" Program					
Fringe Benefits					
Employee Business Expenses					
Worker Classifications/Independent Contractors					
Refund Program (Form 843)					
Call Center					

EXHIBIT A

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY SAMPLE (CONT.)

TRAINING

6. Please indicate your level of satisfaction with any FSLG educational outreach efforts/training you received in the **last 12 months**. Mark "no training" if you have not participated in FSLG educational outreach or attended FSLG training.

	NO TRAINING	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Frequency of training provided					
Availability of education/training options					
Availability of on-line, tutorial educational/training					
Availability of Employer Tax Orientation training					
Confidence in educational/training information reliability					
Subject matter knowledge level of Specialists as trainer(s)					

Voluntary Employer Compliance

Please identify three IRS business practices, policies or requirements which you believe hinder voluntary employment tax compliance by governmental employers.

1. _____
   _____
2. _____
   _____
3. _____
   _____

GENERAL COMMENTS—Employer's perspective

Please identify any other suggestions or comments regarding federal employment tax program administration from your employer's perspective.

1. _____
   _____
2. _____
   _____
3. _____
   _____

EXHIBIT A

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY -- RESULTS

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY					03/18/04
TOTAL SURVEY = 238					
PROGRAM PERFORMANCE					
Please indicate your level of satisfaction with the IRS in the following areas (mark "no experience" if you have not dealt with an item)	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Meeting your tax information needs timely	12.6%	58.0%	9.2%	1.7%	18.5%
Meeting your tax information needs accurately	11.4%	62.2%	4.2%	0.8%	21.4%
Providing training services	7.1%	26.9%	10.1%	0.8%	55.0%
Delivering customer service	7.1%	50.0%	11.8%	1.3%	29.8%
Processing private letter requests--turnaround time/cost	1.7%	17.2%	10.1%	3.8%	67.2%
Providing lead time to implement program and system changes	7.6%	55.5%	8.8%	1.3%	26.9%
Understanding your employer environment	5.0%	41.2%	6.7%	1.7%	45.4%
Providing reliable technical assistance	4.6%	38.7%	10.9%	2.5%	43.3%
Processing employer Form 941, 941c, 843, tax payments/tax refunds	12.2%	64.3%	9.7%	2.1%	11.8%
Performing compliance checks, reviews and audits	2.9%	33.2%	5.9%	0.0%	58.0%
Working with other federal entities (i.e. Social Security Administration)	6.7%	32.8%	7.1%	0.4%	52.9%
TOTAL	7.2%	43.6%	8.6%	1.5%	39.1%
CUSTOMER SUPPORT					
Please indicate your level of satisfaction with your Federal, State, Local Government Specialist (FSLG) in the following areas (mark "no experience" if you have not dealt with the Specialist on an item):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Available for assistance by phone, fax, electronic mail, or in person	13.9%	41.2%	9.2%	2.9%	32.8%
Understand your governmental organization's structure	10.5%	34.0%	6.7%	1.3%	47.5%
Know other IRS functions, services and structures	8.0%	30.7%	3.4%	0.8%	57.1%
Deliver appropriate technical training	6.7%	19.3%	8.4%	0.4%	65.1%
Partner to remove compliance barriers	5.9%	13.0%	4.6%	1.3%	75.1%
Satisfy public employer information needs	6.7%	36.1%	7.6%	3.4%	46.5%
Provide timely turnaround on issues	9.2%	32.8%	9.2%	3.8%	45.6%
Conduct compliance checks, review and audits	3.4%	18.5%	3.4%	1.3%	73.7%
TOTAL	8.0%	28.2%	6.6%	1.9%	55.5%
COMMUNIQUES					
Please indicate your level of satisfaction with IRS on-line products used to meet your employer information needs (mark "no experience" if you do not know the product).	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Digital Dispatch	2.9%	12.6%	0.8%	0.4%	83.2%
e-News	4.6%	23.9%	0.8%	0.4%	70.2%
IRS Newswire	2.1%	11.8%	0.0%	0.4%	85.7%
IRS Tax Tips	4.6%	29.8%	0.4%	0.4%	64.7%
Employee Plan News	1.7%	8.0%	0.8%	0.0%	89.5%
Tax Stats Dispatch	0.8%	3.4%	0.4%	0.4%	95.0%
FSLG Newsletter	3.4%	14.3%	2.1%	1.7%	78.6%
Quick Alerts	2.1%	9.7%	0.8%	0.4%	87.0%
TOTAL	2.8%	14.2%	0.8%	0.5%	81.7%

EXHIBIT A

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY – RESULTS (CONT.)

COMMUNICATION					
Please indicate your level of satisfaction with the following used to meet your "employer" information needs (mark "no experience" if you have not used a product or worked with a listed entity):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
IRS Web Site	18.5%	65.5%	2.9%	0.4%	12.6%
FSLG Web Site	4.2%	14.7%	2.5%	0.4%	78.2%
Ogden Service Center	4.2%	21.4%	2.1%	0.4%	71.8%
Government Liaison	5.0%	11.3%	2.1%	1.3%	80.3%
IRS Publications: Pub 15 Employer's Guide	11.3%	67.6%	1.3%	0.0%	19.7%
Pub 15a Employer's Supplemental Tax Guide	10.1%	60.5%	1.7%	0.0%	27.7%
Pub 15b Employer's Tax Guide to Fringe Benefits	8.8%	51.1%	3.8%	0.0%	35.3%
Pub 463 Travel, Entertainment, Gift & Car Expenses	5.0%	42.9%	1.7%	0.0%	50.4%
Pub 508 Tax Benefits for Work Related Education	3.4%	34.0%	0.8%	0.0%	61.8%
Pub 535 Business Expenses	3.4%	36.1%	1.3%	0.0%	59.2%
Pub 963 Federal-State Reference Guide	5.9%	33.2%	0.4%	0.8%	59.7%
Office of Chief Counsel	0.4%	2.1%	0.8%	0.4%	96.2%
FSLG --Area Groups/Specialists and Outreach, Planning/Review staffs	4.6%	12.6%	2.9%	0.8%	79.0%
Taxpayer Advocate Service Office	1.7%	7.1%	0.8%	0.8%	89.5%
Customer Account Services	0.8%	18.5%	2.5%	1.3%	76.9%
Wage and Investment	0.4%	4.2%	0.0%	0.4%	95.0%
Subscriptions to Tax and Payroll Informational Services	4.2%	13.9%	0.4%	0.4%	80.7%
TOTAL	5.4%	29.3%	1.7%	0.4%	63.2%

PROGRAM ADMINISTRATION					
Please indicate your level of satisfaction with IRS administration for the following programs (mark "no experience" if you have not dealt with a listed item):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Collections	1.3%	23.5%	3.4%	0.4%	71.4%
Informational Reporting (W-2)	6.7%	72.3%	2.5%	1.3%	17.2%
Informational Reporting (1099)	5.0%	60.5%	2.5%	0.8%	31.1%
Federal Filing Requirements (941, 941c, etc.)	7.1%	71.4%	5.0%	1.3%	15.1%
Electronic Fund Transfer Tax Payment System (EFTPS)	23.9%	51.3%	0.8%	0.4%	23.4%
Form W-4 "Lock-In Letter" Program	1.7%	7.6%	0.4%	1.3%	89.1%
Fringe Benefits	3.4%	27.7%	3.4%	1.3%	64.3%
Employee Business Expenses	2.1%	20.6%	2.1%	0.4%	74.8%
Worker Classifications/Independent Contractors	1.7%	24.8%	3.8%	0.8%	68.9%
Refund Program (Form 843)	0.8%	4.2%	2.1%	0.8%	92.0%
Call Center	2.9%	21.4%	9.2%	1.3%	65.1%
TOTAL	5.2%	35.0%	3.2%	0.9%	55.7%

TRAINING					
Please indicate your level of satisfaction with any FSLG educational outreach efforts/training you received in the last 12 months. Mark "no training" if you have not participated in FSLG educational outreach or attended FSLG training.	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO TRAINING
Frequency of training provided	3.4%	13.0%	7.1%	0.4%	76.1%
Availability of education/training options	3.8%	13.0%	6.7%	0.8%	75.6%
Availability of on-line, tutorial educational/training	1.3%	3.4%	3.8%	0.8%	90.8%
Availability of Employer Tax Orientation training	1.7%	7.1%	3.4%	0.8%	87.0%
Confidence in educational/training information reliability	6.3%	13.4%	2.9%	0.0%	77.3%
Subject matter knowledge level of Specialists as trainer(s)	10.1%	9.7%	2.1%	0.0%	78.2%

TOTAL	4.4%	9.7%	4.3%	0.5%	80.8%
OVERALL	5.6%	28.9%	4.0%	0.9%	60.6%

EXHIBIT A
VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY- COMMENTS

Please identify three IRS business practices, policies or requirements which you believe hinder voluntary employment tax compliance by governmental employers. Note: Comments were not edited.

1. IRS does not respond quickly to user needs nor applies enough time or resource to meeting legitimate employer needs.
2. Communication between various IRS groups that interface with the same employer regarding training and compliance issues is virtually nonexistent – the right hand does not know what the left hand is doing.
3. IRS rules and regulations are administratively extremely difficult to follow… IRS needs to write regulations that whenever possible, provide objective and quantitative standards (bright line tests).
4. IRS employees refused to put advice in writing. They advise obtaining private letter rulings which are expensive and time consuming.
5. FSLG staff view function as raising revenue versus assisting in compliance though they advertise it as their mission.
6. The technical staff assigned to assist governments is not as trained or experienced as other IRS staff. FSLG is not a priority with the IRS.
7. IRS Philadelphia unilaterally refunds employee FICA taxes and notifies us (employer) to correct our records. It is suggested the employer be given an opportunity to research the claim and if appropriate make the refund.
8. IRS refund checks do not provide enough information to identify what the refund is for.
9. IRS automatically allocates credits to other taxes without communicating with the employer. This process makes our reconciliation more difficult.
10. Large employee turn over requires continual education programs.
11. Private letter rulings are slow (up to 2 years) & can cost up to $40-$50,000.
12. Regression in uniform/timely release of employment tax information.
13. Lack of education for these employers as to their employment tax requirements/responsibilities.
14. Lack of a uniform, formal voluntary compliance program for these employers.
15. Finding an IRS contact to resolve an issue. Wading through the various divisions hoping to find a department title that can assist with resolving a specific tax issue is a very frustrating and time-consuming task.
16. Lack of apparent interaction with SSA to resolve tax and coverage issues usually guarantees differing interpretations.
17. Inability of IRS to resolve tax issues in a timely manner.
18. Complexity of the tax code and the ability to be understood by a large portion of the payroll community.
19. Not contacting State Administrators about compliance checks before visiting the agency.
20. Discontinuing workshops that help educate employers.
21. IRS should automatically supply Publication 963 to state and local employers.
22. Unclear instructions.
23. Unavailability of an expert at the call center.
24. Lack of confidence in knowledge the person answering the question.
25. Publications and/or instructions can be very confusing & hard to correctly interpret.
26. If FSLG training is available, more info on it needs to be sent out. Need it in all areas – not just big cities.
27. Talking with a different person each time you call the service center.
28. Cellular telephone – taxable fringe benefit – this should be classified as a de-minimus benefit – booking nightmare!
29. Lack of training.
30. Regulations are not easy to understand
31. Elimination of Next Day payment of taxes for larger $ payrolls.
32. 30-day response time for letters sent by the IRS may not be enough time due to the postal system.
33. Interest & penalties are assessed & levied before we have time to correct the problem or respond to letters issued by IRS.
34. Clarification of Section 125 certification.
35. No definitive rules for independent contracts -- they are guidelines that you have to decide for yourself.
36. $100,000 Next Day deposit rule… dollar amount should be raised or moved to semi-weekly deposit.
37. Web based quarterly reporting with fileable 941 and schedules would simplify reporting without having to pay for third party software.
38. It seems that the Schedule B of the 941 is not always posted even when the Schedule B is attached to the 941. Then you provide the information numerous times and the situation still does not get taken care of. Then the IRS levies your bank account.
39. As a policy, we make sure the 941s equal the W-3 before we send in the W-3 and W-2s, then we still get letters saying the wages don't match.
40. Regular "briefs" would be very beneficial instead of always the complete supplement.

Barriers to Voluntary Compliance:
Governmental Employers' Perspective

41. IRS response is slow and fails to apply resources to meet real needs.
42. Communication is strained within IRS – the various IRS units don't know what other units are doing or why they are doing it.

EXHIBIT A

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY- COMMENTS (C0NT.)

43. IRS regulations are too complex and hard to follow. IRS should break down the complexity and use bright line measurements; need to simplify.
44. Paying for private letter rulings are too expensive and slow. IRS employees will not commit direction or guidance to writing. IRS leaves it customers hanging.
45. FSLG says its mission is assisting in compliance; its actions reflect revenue generation as a priority.
46. FSLG seems like it has no priority.
47. Complicated tax rules and regulations and how to apply them to an entity's payroll process.
48. Compliance with modifications of technical systems.
49. Clarification of some publication.
50. Updating of IRS website.
51. Reply delays of 3 months or longer.
52. Complexity of requirements.
53. Lack of reliable source of answers to tax questions.
54. Unwillingness of IRS to put answers in writing without taxpayer requesting a PLR.
55. Posting W-2's accurately.
56. De minimis is too small.
57. Tax withholding for "Election Employees" is too difficult to put into realistic practice. All election employees have to be looked at individually and handled manually. Can't automate.
58. IRS refunds employee FICA taxes and then tells employers to fix employer records. Shouldn't IRS check with employers before refunding?
59. Not enough information to identify what refunds are for.
60. Reconciliation is hard enough—it is made harder when IRS automatically credits refunds to employer accounts without talking to employers to make sure that the right EIN account is posted to.
61. The service has to either get serious about W-4 compliance or stop requiring employers to submit exempt or more than 10 deductions on W-4s. Requiring the employers to monitor this information is completely useless if it's never enforced.
62. We had a situation where we sought guidance on a relatively new taxation issue and requested support from our FSLG specialties and received no direction.
63. Whenever there is an error it takes --- forever --- to resolve the problem.
64. You never know if correspondence was received or if it went into the "Black Hole".
65. Notice when reporting/depositing requirements are change – No notice is given until IRS catch it.
66. I like free training --- more training in the forms/annual payroll, etc.
67. Instructions are often too complicated for some employers to understand… keep it simple.
68. Change requirements for next day deposit for deposit over $100,000.
69. It's normal to talk to "many different individuals when trying to get a problem resolved & can be told something different by each one.
70. IRS will remove a payment from another tax return (990-T and apply it to tax area ((41) when the issue on the 941 has already been addressed. The Service Center Agents are sometimes unable to return the funds to the correct tax account for the university.
71. Continual slow process of applications for W-7 forms – Individual Taxpayer Identification Numbers (ITINS). It has been taking a least 2 months to get the ITIN back from the IRS.
72. Applying retroactive adjustments to Form 104 when a negative amount results.
73. Not offering a state agency <115(a)> a similar letter of determination <501(c)(31)> for grantors.
74. Requiring universities and colleges to report Form 1098-T information.
75. Lack of information being provided to person who disseminates.
76. Lack of crossover among offices or sites that answer similar questions.
77. Lack of ability to respond to entire problem
78. One office would not even speak to me as I was not a practitioner nor official, would only respond to practitioners.
79. Not having a W-4NR for non-resident alien employees.
80. Taxable fringe benefits for cars – need better definitions.
81. Earned Income Credit – forms are difficult for employees to complete.
82. Availability of authoritative guidance on tax issues. Pubs are great info but are not authoritative.
83. Difficult to reach anybody when needed.
84. A few of the individuals that I have talked with did not have a clue to solve the problems.
85. Publication/manual & form could have been simplified to make the job easier.
86. As a result of overlapping regulations, "compliance" is not quite clear.

Barriers to Voluntary Compliance:
Governmental Employers' Perspective

87. Technical guidance is not clearly stated.
88. Technical folks seem uncertain of correct action or we receive differing opinions.
89. EFTPS set up to Internet not very easy.
90. The change from disk reporting to wire/Internet reporting will be difficult for our agency.
91. Expectation that we will know what's wanted for compliance – but no training.

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY- COMMENTS (C0NT.)

92. Inability to receive clear directions.
93. Lack of communication.

EXHIBIT A

GENERAL COMMENTS—EMPLOYER'S PERSPECTIVE SURVEY- COMMENTS

Please identify any other suggestions or comments regarding federal employment tax program administration from your employer's perspective.

1. Employers should be able with a high degree of confidence to secure and apply information that enables them to voluntarily comply with tax law. IRS, through its business practices continues to create a hostile compliance environment and creates barriers that impede voluntary compliance.
2. Simplify the tax deposit requirements for semiweekly depositors by eliminating the $100,000 next day deposit requirement and adopting a fixed deposit period schedule.
3. Remove deposit penalty rules or rewrite to include thresholds to identify and apply to abusers.
4. Apply tax deposits as directed by the employer.
5. When we submit a 941c the IRS always asks for another copy of the 941c to justify the adjustments. What happened to the original 941c?
6. FSLG specialist holds training and then tells employers to call us to get copy of 218 agreement.
7. FSLG rep in Alaska (Gary Petersen) is wonderful to work with. Very helpful & responsive.
8. The creation of FSLG with its focus on govt. employers was a positive step.
9. IRS needs to partner with SSA to enhance their website. In addition, IRS needs to take control of their respective tax forms that have been produced through public funds. Requiring entity to pay a vendor to produce their tax form is absurd.
10. I welcome any helpful comments or news items – our contact(s) have always been very beneficial.
11. Overall, I have been very pleased with the IRS representative for my state.
12. It is imperative the IRS continue the education process via workshops. Retirement of key personnel in the next 5-10 years will have a detrimental impact on state and local & federal government agencies.
13. The fact that the IRS requires us to submit certain W-4 forms for review and then does not conduct the review hinders compliance.
14. Assigned tax liaison is a person we must reach by long distance. Voice mail says they will make attempts to answer calls in 5 business days. That level of response simply does not work. Liaison person knows nothing about our business, has little experience, is not invested in our success, does not measure paltry tax issues against our total tax payments, and does not follow up timely.
15. Fear loss of outreach and information resources as IRS staff is now focusing on compliance review.
16. Large # of forms should be available. Employers should not have to stand the cost of mandatory forms (W-2's).
17. There have been great strides by the IRS & SSA made in the last 10 years. The IRS specialist I spoke to was not knowledgeable enough to give me an answer. They just gave me a web-site to search to find the answer. A vocal response would be better.
18. Very frustrated with response from Ogden via letters – took over a year to clear up and intervention from a local IRS agent (which then it was cleared within the month).
19. I think most employers really are trying to complete the forms to the best of their ability and understanding to be honest in their business practice.
20. I was called by an IRS tax advocate last month concerning one of our landlords which had a lien placed against them in error. It was handled very efficiently by the advocate and the lien was removed within a couple of days. I was very impressed.
21. I am very satisfied with all of the correspondence & training from IRS & SSA.
22. Notices should be relevant to the specific situation instead of standardized notices.
23. Response to correspondence is very, very slow. Rules on worker classifications need to be simplified.
24. FLSG Liaison did not understand our large government problems and did nothing to solve our issues. Never available to take calls, never returned calls, never helped in any constructive way.
25. Why does IRS separate 941c from the original 941? They always ask for backup copies of the 941c to justify any adjustment.
26. Under the recent structure of the IRS, dealing with Ogden, Utah makes problem resolution virtually impossible. We can easily deal with the local FSLG representative and fellow staff. However, no one at the local level is empowered to physically access our account and make corrections. We have literally spent years reconciling our withholding account with the IRS. Even though we can agree locally, adjustments must be made in Ogden by a stranger who did not have the benefit of reconciling several quarters worth of transactions, most of which were incorrect adjustments initiated by the service center. The inordinate delays in making corrections cause additional unnecessary transactions and the cycle repeats itself. It would seem that a customer striving to comply and sending over $26 million annually would receive better service.
27. It would be helpful to provide employers with written procedures for dealing with employees who question the legality of the federal tax laws and to receive written support from the IRS of our need to comply with your tax

regulations for these individuals. Dealing with these employees is time consuming and it is hard to satisfy them with a verbal response from the IRS. At times, they bring their union representatives into the process, and they are doubly hard to satisfy.

EXHIBIT A

GENERAL COMMENTS—EMPLOYER'S PERSPECTIVE SURVEY- COMMENTS (CONT.)

28. More communication is necessary between Ogden Service Center and other IRS facilities.
29. Simply the tax deposit requirements for semiweekly by eliminating the $100,000 next day deposit requirement and adopting a fixed deposit period schedule.
30. Remove deposit penalty rules or rewrite to include thresholds to identify and apply to abusers.
31. Apply tax deposits as directed by the employer.
32. Please find persons who can answer problems & respond quickly.
33. We have received 941 penalty notices for almost every quarter for the past two years. Every problem has been an IRS error and all penalties have been removed. However, there is a great deal of effort expended by the IRS and employer that could have been avoided by carefully handling the 941 returns.
34. I would like to be able to do 941s online each quarter. Monthly reporting is a breeze with web reporting as is the W-2 transmissions.
35. Most gov employers want to comply -- it is usually lack of knowledge and that hinders ones effectiveness. Your sensitivity to the situations is always appreciated.
36. It would be helpful to reach a live person to direct you, especially in cases where you're not sure where you want to end up.
37. It's difficult to get EFTPS transferred from phone to Internet.
38. Quicker response on e-mail inquires would be helpful.
39. If we could help in designing a program to help in the education of our employees for fringe benefits and business expenses that would be a tremendous help.
40. It would be nice if they had regional seminars for payroll clerks to attend.
41. IRS should call employers ASAP when discovering mistakes or errors in withholding payments for quick fixes!
42. Local training – even through conference calls
43. I would like information for online submission of 941, 1099 and W-2's.
44. Very difficult to get through on phone, then get transferred several times and eventually disconnected.
45. For the past 5 quarters, there have been problems with the processing of our 941 reports. Always get notices that the submittal was missing the Schedule B which is not accurate.
46. It can be very frustrating when we try to fully understand how to comply and the technical guidance we receive seems to be uncertain or cannot provide specific citations.
47. Provide simple and easy to understand instructions/publications.
48. Provide "faster" help for employers to solve problems – courtesy & respect to every caller, as we employers have to provide the best customer service to our customers/employees.
49. If you could have the federal tax tables ready in early December if would be very helpful.
50. Laws are too many and complicated.
51. Private Letter ruling letters take too long for answers.
52. The IRS had a web site that would allow taxpayers to submit questions. That service is no longer available effective January 1, 2004 – wish the service could be reinstated.

EXHIBIT B

FSLG SPECIALIST FEEDBACK INFORMATION

BARRIERS TO VOLUNTARY EMPLOYER TAX COMPLIANCE SAMPLE SURVEY

PROGRAM PERFORMANCE

1. Please assess your level of satisfaction with the IRS in the following areas (mark "no experience" if you have not dealt with an item):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Meeting your program information needs timely/accurately					
Providing viable training that enables you to address employer issues					
Delivering quality support services to FSLG Specialists					
Supporting suggestions to improve products/services					
Providing lead time to implement program and procedural changes (i.e. compliance checks, audits,, etc)					
Understanding stakeholders' political and organizational structures					
Providing reliable technical publications					
Resolving account issues/returns (Forms 941, 941c, 843, tax payments and tax refunds					
Inputting to case selection issues					
Working effectively with TE/GE groups (EO, EP, etc.) to solve employer issues					
Working effectively with Social Security Adm. to solve employer issues					

CUSTOMER SUPPORT

2. Please indicate your satisfaction regarding the percentage of time allocated (spent) to assist employers (mark "no experience" if you have no dealt with an item):

	NO EXPERIENCE	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Being available by phone, fax, electronic mail, or in person to provide services					
Assisting each employer in your assigned geographical area					
Knowing other IRS functions, services and structures to assist employers					
Delivering appropriate technical training					
Partnering with employers to remove compliance barriers					
Satisfying employer information needs					
Providing timely turnaround on issues					
Conducting compliance checks, review and audits professionally					

COMMUNIQUES

3. Please assess the value of the following IRS on-line products to satisfy your customers "employer" tax information needs (mark "no experience" if not familiar with a product):

	NO EXPERIENCE	NOT VALUABLE	SOMEWHAT VALUABLE	VALUABLE	VERY VALUABLE
Digital Dispatch					
e-News					
IRS Newswire					
IRS Tax Tips					
Employee Plan News					
Tax Stats Dispatch					

FSLG Newsletter					
Quick Alerts					

EXHIBIT B

BARRIERS TO VOLUNTARY EMPLOYER TAX COMPLIANCE SAMPLE SURVEY - (CONT.)

COMMUNICATION

4. Please assess the value of IRS services/products to enable employers to voluntarily understand and comply with tax law (mark "no experience" if you have not dealt with an item):

	NO EXPERIENCE	NOT VALUABLE	SOMEWHAT VALUABLE	VALUABLE	VERY VALUABLE
IRS Web Site					
FSLG Web Site					
Ogden Service Center					
Other Service Centers					
IRS Publications: Pub 15 Employer's Guide					
Pub 15a Employer's Supplemental Tax Guide					
Pub 15b Employer's Tax Guide to Fringe Benefits					
Pub 463 Travel, Entertainment, Gift and Car Expense					
Pub 508 Tax Benefits for Work Related Education					
Pub 535 Business Expenses					
Pub 963 Federal-State Reference Guide					
Chief Counsel's Office/Area Counsel					
FSLG Outreach, Planning and Review staff					
FSLG Group Manager					
On-line FSLG data resources					
Customer Account Services					

PROGRAM ADMINISTRATION

5. Please assess how successful you feel IRS has been in administering the following programs with FSLG's customers (mark "no experience" if you have not dealt with a listed item):

	NO EXPERIENCE	VERY UNSUCCESSFUL	UNSUCCESSFUL	SUCCESSFUL	VERY SUCCESSFUL
Collections					
Informational Reporting (Form1099, W-2, etc.)					
Federal Filing Requirements (Form 941, 941c, etc.)					
EFTPS					
Form W-4 Lock-In Letters					
Fringe Benefits					
Employee Business Expenses					
Worker Classification					
Section 115/Political Subdivisions					

TRAINING

6. Please indicate whether the percentage time spent training/outreaching with your customers in the last 12 months (including training materials used) was sufficient to meet your customer's needs. Mark "no training" if you have not provided training or educational outreach in the past 12 months.

	NO TRAINING	VERY INSUFFICIENT	INSUFFICIENT	SUFFICIENT	VERY SUFFICIENT
Frequency of training provided					
Frequency of outreach services performed					

Availability of on-line, tutorial training tools					
Availability of classroom training materials					
Confidence in training materials reliability					
Frequency of partnering with other Federal or State entities in training					

EXHIBIT B

BARRIERS TO VOLUNTARY EMPLOYER TAX COMPLIANCE SAMPLE SURVEY - (CONT.)

Barriers to Voluntary Employer Compliance

Based upon your FSLG Specialist experience, please identify three barriers regarding IRS business practices, policies or requirements which you believe prevent voluntary tax compliance by your customers--governmental employers.

1. _____
   _____
2. _____
   _____
3. _____
   _____

GENERAL COMMENTS—Employers Perspective Regarding Tax Administration

Based on your customer interfaces, what are the most frequent complaints expressed to you by public sector employers regarding IRS and employment tax compliance?

1. _____
   _____
2. _____
   _____
3. _____
   _____

EXHIBIT B

BARRIERS TO VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY RESULTS

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY 02/02/04

FSLG SURVEY = 15

PROGRAM PERFORMANCE

Please assess your level of satisfaction with the IRS in the following areas (mark "no experience" if you have not dealt with an item):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Meeting your program information needs timely/accurately	0%	60%	33%	7%	0%
Providing viable training that enables you to address employer issues	27%	60%	7%	7%	0%
Delivering quality support services to FSLG Specialists	13%	20%	47%	13%	7%
Supporting suggestions to improve products/services	7%	27%	27%	27%	13%
Providing lead time to implement program and procedural changes	0%	47%	20%	27%	7%
Understanding stakeholders' political and organizational structures	7%	60%	13%	20%	0%
Providing reliable technical publications	7%	80%	13%	0%	0%
Resolving account issues/returns	13%	47%	33%	7%	0%
Inputting to case selection issues	13%	33%	27%	13%	13%
Working effectively with TE/GE groups to solve employer issues	7%	40%	7%	27%	20%
Working effectively with Social Security Adm. to solve employer issues	33%	40%	13%	7%	7%
TOTAL	12%	47%	22%	14%	6%

CUSTOMER SUPPORT

Please indicate your satisfaction regarding the percentage of time allocated (spent) to assist employers (mark "no experience" if you have not dealt with an item):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Being available by phone, fax, electronic mail, or in person to provide services	40%	47%	13%	0%	0%
Assisting each employer in your assigned geographical area	33%	53%	13%	0%	0%
Knowing other IRS functions, services and structures to assist employers	20%	33%	40%	7%	0%
Delivering appropriate technical training	7%	60%	27%	7%	0%
Partnering with employers to remove compliance barriers	7%	60%	7%	13%	13%
Satisfying employer information needs	7%	73%	20%	0%	0%
Providing timely turnaround on issues	0%	60%	33%	7%	0%
Conducting compliance checks, review and audits professionally	20%	67%	0%	13%	0%
TOTAL	17%	57%	19%	6%	2%

COMMUNIQUÉS

Please assess the value of the following IRS on-line products to satisfy your customers "employer" tax information needs (mark "no experience" if not familiar with a product):	VERY VALUABLE	VALUABLE	SOMEWHAT VALUABLE	NOT VALUABLE	NO EXPERIENCE
Digital Dispatch	0%	13%	13%	0%	73%
e-News	0%	13%	13%	0%	73%
IRS Newswire	0%	7%	13%	0%	80%
IRS Tax Tips	0%	27%	27%	0%	47%
Employee Plan News	7%	20%	0%	7%	67%
Tax Stats Dispatch	0%	7%	0%	0%	93%
FSLG Newsletter	53%	20%	13%	7%	7%
Quick Alerts	7%	13%	7%	0%	73%
TOTAL	8%	15%	11%	2%	64%

EXHIBIT B

BARRIERS TO VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY- RESULTS (CONT.)

COMMUNICATION

Please assess the value of IRS services/products to enable employers to voluntarily understand and comply with tax law (mark "no experience" if you have not dealt with an item):	VERY VALUABLE	VALUABLE	SOMEWHAT VALUABLE	NOT VALUABLE	NO EXPERIENCE
IRS Web Site	36%	36%	21%	0%	7%
FSLG Web Site	29%	36%	21%	0%	14%
Ogden Service Center	0%	14%	21%	43%	21%
Other Service Centers	0%	14%	7%	29%	50%
IRS Publications: Pub 15 Employer's Guide	43%	29%	21%	0%	7%
Pub 15a Employer's Supplemental Tax Guide	43%	36%	14%	0%	7%
Pub 15b Employer's Tax Guide to Fringe Benefits	50%	29%	14%	0%	7%
Pub 463 Travel, Entertainment, Gift and Car Expense	50%	29%	14%	0%	7%
Pub 508 Tax Benefits for Work Related Education	20%	27%	33%	0%	20%
Pub 535 Business Expenses	21%	43%	29%	0%	7%
Pub 963 Federal-State Reference Guide	57%	29%	7%	0%	7%
Chief Counsel's Office/Area Counsel	20%	13%	13%	33%	20%
FSLG Outreach, Planning and Review staff	13%	20%	20%	33%	13%
FSLG Group Manager	20%	33%	7%	20%	20%
On-line FSLG data resources	20%	27%	20%	13%	20%
Customer Account Services	27%	0%	33%	13%	27%
TOTAL	28%	26%	19%	12%	16%

PROGRAM ADMINISTRATION

Please assess how successful you feel IRS has been in administering the following programs with FSLG's customers (mark "no experience" if you have not dealt with a listed item):	VERY SUCCESSFUL	SUCCESSFUL	UNSUCCESSFUL	VERY UNSUCCESSFUL	NO EXPERIENCE
Collections	0%	13%	13%	33%	40%
Informational Reporting (Form1099, W-2, etc.)	13%	53%	27%	7%	0%
Federal Filing Requirements (Form 941, 941c, etc.)	20%	53%	27%	0%	0%
EFTPS	13%	60%	0%	0%	27%
Form W-4 Lock-In Letters	7%	7%	0%	20%	67%
Fringe Benefits	20%	53%	20%	7%	0%
Employee Business Expenses	13%	20%	33%	7%	27%
Worker Classification	7%	47%	40%	0%	7%
Section 115/Political Subdivisions	0%	0%	20%	0%	80%
TOTAL	10%	34%	20%	8%	27%

TRAINING

Please indicate whether the percentage time spent training/outreaching with your customers in the last 12 months (including training materials used) was sufficient to meet your customer's needs. Mark "no training" if you have not provided training or education	VERY SUFFICIENT	SUFFICIENT	INSUFFICIENT	VERY INSUFFICIENT	NO TRAINING
Frequency of training provided	13%	40%	47%	0%	0%
Frequency of outreach services performed	20%	33%	40%	7%	0%
Availability of on-line, tutorial training tools	7%	13%	20%	0%	60%
Availability of classroom training materials	21%	57%	0%	7%	14%
Confidence in training materials reliability	40%	47%	13%	0%	0%
Frequency of partnering with other Federal/State entities in training	27%	20%	13%	20%	20%

	21%	35%	22%	6%	16%
OVERALL	17%	35%	19%	9%	21%

EXHIBIT B

Barriers to Voluntary Employer Compliance Survey -COMMENTS

Based upon your FSLG Specialist experience, please identify three barriers regarding IRS business practices, policies or requirements which you believe prevent voluntary tax compliance by your customers--governmental employers. Note: Comments were not edited.

1. Difficulty of obtaining timely, accurate, and courteous service from Service Center functions.
2. The inability or unwillingness of IRS consul to provide timely and specify written guidance regarding unique issues.
3. Unaware of these tax laws and our (FSLG) sudden escalation of conducting workshops.
4. It's yet to happen, but in the future I believe we will be limited to time changes to customers frequent via e-mail, telephone. Etc.,
5. The IRS wants to treat a state like a business. For example TIN mismatch penalties when the state issues 50,000 1099s and has less than ½% error rate. – They can't get 100% accurate, we need to be realistic.
6. Collection is assessing tax or levying our customers while we are trying to assist them.
7. Compliance checks aren't controlled or indicated on IDES. Focusing on audits instead of outreach activities and compliance checks will cause customers to be less candid, inhibiting voluntary compliance.
8. Drastically reducing outreach activities will limit the number of taxpayers we can reach with information to one-on-one audits.
9. Newly Elected Officials need training on substantially the same issues each year.
10. Elected/Control employees put pressure on payroll offices not to report taxable fringe benefits to them.
11. Gov. budget constraints sometimes lead to reclassification of employees to independent contractors to save on payroll taxes.
12. Lack of cohesion and purpose between TEGE functions—crossover issues aren't being addressed, i.e., interplay between allowable benefits (like post-retirement medical benefits plans) and employment taxes.
13. Lack of guidance on alien withholding for governmental entities.
14. Where to find internal information throughout the IRS.
15. National office is rigid in their policies. They are not successful in a state which is small & has only one statewide local govt.
16. The outreaches are not being conducted to small govt. that can't send someone to a meeting at another location.
17. To early for --- focus on exams, more outreach education is still needed.
18. Exams are drastic swings form previous years.
19. Lack of knowledge of how states are organized and how they work. This includes how they are financed and what are the local politics of the entity.
20. Lack of information on 941 for proper classification of returns for exam. There could be a special 941 for Government entities that has questions about the entity and their 218 agreement or that they have no agreement. (a 941-form).
21. Managers do not have the appropriate skills to manage and they do not have a functional understanding of the requirements of the job. Resources are not appropriately allocated and utilized to reach program objectives.
22. FLSG does not know its customers and their needs to administer the tax laws.
23. IRS educational products need to be more user-friendly.
24. Based on the internal political hierarchy within TE/GE, FSLG does not receive adequate support to adequately implement program objectives. This failure directly affects the quality of the practices, policies, and requirements within FSLG.
25. Compliance checks selected when there are indicators of missing or diligent returns.
26. Lack of technical alert from OPR.

27. Lack of communication per voice mail from the Directors office and OPR.
28. We need to survey our customers – government employers—to determine their needs.

EXHIBIT B

Employers Perspective Regarding Tax Administration Survey - COMMENTS (CONT.)

Based on your customer interfaces, what are the most frequent complaints expressed to you by public sector employers regarding IRS and employment tax compliance?

1. The unresponsiveness, unreasonable, and ignorance/arrogance of Service Center Collection personnel.
2. The ones that attended the IRS workshops wanted them annually. Once they found out our business plan was steering away from outreaches, they were very disappointed.
3. A public employer can't just write a check to pay a tax assessment like a private company can.
4. Penalties are not reasonable
5. It takes council forever to issue an opinion.
6. The Ogden Service Center has not been helpful in resolving governmental employer attempts to resolve issues involving penalties.
7. Customers can seldom get meaningful help from the service center phone numbers shown on IRS notices.
8. It's hard for rank-and-file staff members of public employers to get training on employment tax requirements.
9. Notices are difficult to understand.
10. The most frequent complaint I hear is about the Service Centers. Unresponsive IRS employees. Forms lost that an employer has sent in. This lack of customer assistance frustrates the employers and leads to negative impressions of the IRS.
11. We have never been audited so why are we now (subject to exam)?
12. Where can we find information specific to governmental entities?
13. Lack of training & understanding of the laws
14. No direct Pub's for employers that are not taxed.
15. Don't know who to contact.
16. Unable to reach IRS Service Centers.
17. I am often asked when we will be teaching IRS classes again in any state.
18. More, most are pleased with the new office that was created for government entities.
19. They often complain that we "never told them this before".
20. Why haven't they been informed about these matters or issues by their internal or independent auditors?
21. Their employees are very low paid anyway---fringe benefits are the only way they can compensate them.
22. We are being "petty" about the cell phones. Cell phones should be treated the same as any other phone.
23. Inconsistent answers to their tax questions: knowing whom to contact about their tax issues; penalties erroneously assessed; deposit problems with Service Centers.

EXHIBIT C

IRS CAMPUS FEEDBACK INFORMATION

IRS CAMPUS FEEDBACK INFORMATION SAMPLE SURVEY

CUSTOMER CONTACT

Please assess the level of expertise demonstrated by federal, state and local government customers regarding their "employer" tax role (mark "no opinion if no experience with an item):

	NO OPINION	NO SKILLS	MINIMAL SKILLS	SKILLED	VERY SKILLED
Federal agencies					
State agencies					
County agencies					
City agencies					
School districts					
Other agencies (i.e. special districts, quasi governmental entities, etc.)					

Comments/Suggestions: _____

PROGRAM PERFORMANCE

Please assess your level of satisfaction in the following areas when dealing with public sector employers (mark "no opinion" if no experience with an item):

	NO OPINION	VERY DISSATISFIED	DISSATISFIED	SATISFIED	VERY SATISFIED
Meeting employers' informational needs timely					
Initiating regular contact with these employers					
Understanding your customers' employer environments					
Directing employers to other IRS functions, services & structures to resolve their problems					
Providing accurate technical assistance to employers					
Providing training to employers re employment tax responsibilities accounts					
Partnering with employers to remove compliance barriers					
Working employer accounts to your expectations					
Working with other IRS areas to promote voluntary compliance					

Comments/Suggestions: _____

CUSTOMER PROBLEMS

Please assess how serious you feel the following problems are when working with public sector employers (mark "no opinion" if no experience with an item):

	NO OPINION	NOT SERIOUS	LESS SERIOUS	SERIOUS	VERY SERIOUS
Each EIN entails working with many customers versus a single contact					
Different customers with one EIN routinely ask the same repetitive questions					
Customers ask you to perform services outside your control					
Customer turnover requires constant retraining of new customers					
Customers do not understand how IRS works nor its organizational structure					
Customers do not have IRS reference/instructional materials (i.e. Employer Guide, Supplemental Employer's Guide, etc)					
Customers do not understand IRS reference/instructional materials					
Customers are difficult to contact					
Customers are too proactive					

Customers require training outside your area of responsibility					

Comments/Suggestions: _____

EXHIBIT C

IRS CAMPUS FEEDBACK INFORMATION SAMPLE SURVEY - (CONT.)

CLIENT KNOWLEDGE

How proficient do you believe your customers are in dealing with the following subject matters (mark "no opinion" if no experience with item):

	NO OPINION	NOT PROFICIENT	LESS PROFICIENT	PROFICIENT	VERY PROFICIENT
Form 941 requirements/form completion					
Form 941 C requirements/form completion					
Tax Deposit processes/requirements					
Form W-2 requirements/reporting					
Form W-2c requirements/reporting					
Power of Attorney Requirements					
Form 1099 Reporting requirements/reporting					
Penalty and interest assessment processes					
Appeal process for penalties and assessments					
Role of service center IRS campus personnel					

Comments/Suggestions: _____

CUSTOMER AWARENESS

Please assess problems your customers most frequently cite which impact voluntary employment tax compliance (mark "no opinion if no experience with item):

	NO OPINION	NOT A PROBLEM	PROBLEM	MINOR PROBLEM	MAJOR PROBLEM
IRS rules and regulations are too vague					
IRS rules and regulations are too complicated					
Employers cannot find information required to perform the job					
Instructional tools and publications create questions/not answer them					
IRS representatives provide conflicting information on routine matters					
IRS is not responsive					
IRS refund process is cumbersome and slow					
IRS is too fragmented					
IRS does not understand employer's problems					
Other (use comment/ suggestion area to explain)					

Comments/Suggestions: _____

GENERAL COMMENTS- what should be done to remove barriers that prevent voluntary customer compliance?

_____

_____

_____

EXHIBIT C

IRS CAMPUS FEEDBACK INFORMATION SURVEY RESULTS

VOLUNTARY EMPLOYER TAX COMPLIANCE SURVEY					02/02/04
IRS CAMPUS SURVEY = 12					
CUSTOMER CONTACT					
Please assess the level of expertise demonstrated by federal, state and local government customers regarding their "employer" tax role (mark "no opinion if no experience with an item):	VERY SKILLED	SKILLED	MINIMAL SKILL	NO SKILLS	NO OPINION
Federal agencies	8%	42%	8%	8%	33%
State agencies	0%	50%	17%	0%	33%
County agencies	0%	33%	33%	0%	33%
City agencies	0%	42%	17%	0%	42%
School districts	0%	33%	25%	0%	42%
Other agencies	0%	25%	8%	0%	67%
TOTAL	1%	38%	18%	1%	42%
PROGRAM PERFORMANCE					
Please assess your level of satisfaction in the following areas when dealing with public sector employers (mark "no opinion" if no experience with an item):	VERY SATISFIED	SATISFIED	DISSATISFIED	VERY DISSATISFIED	NO EXPERIENCE
Meeting employers' informational needs timely					
Initiating regular contact with these employers	8%	50%	17%	0%	25%
Understanding your customers' employer environments	0%	50%	25%	0%	25%
Directing employers to other IRS functions, services, structures to resolve problems	0%	92%	8%	0%	0%
Providing accurate technical assistance to employers	8%	83%	8%	0%	0%
Providing training to employers: employment tax responsibilities accounts	0%	50%	33%	0%	17%
Partnering with employers to remove compliance barriers	0%	33%	33%	0%	33%
Working employer accounts to your expectations	8%	83%	8%	0%	0%
Working with other IRS areas to promote voluntary compliance	0%	42%	33%	0%	25%
TOTAL	4%	62%	19%	0%	16%
CUSTOMER PROBLEMS					
Please assess how serious you feel the following problems are when working with public sector employers (mark "no opinion" if no experience with an item):	VERY SERIOUS	SERIOUS	LESS SERIOUS	NOT SERIOUS	NO OPINION
Each EIN entails working with many customers versus a single contact	8%	50%	8%	17%	17%
Different customers with one EIN routinely ask the same repetitive questions	0%	8%	25%	25%	42%
Customers ask you to perform services outside your control	0%	8%	33%	25%	33%
Customer turnover requires constant retraining of new customers	0%	8%	50%	25%	17%
Customers do not understand how IRS works nor its organizational structure	0%	25%	33%	33%	8%
Customers do not have IRS reference/instructional materials (i.e. Employer Guide)	0%	25%	17%	33%	25%
Customers do not understand IRS reference/instructional materials	0%	33%	42%	17%	8%
Customers are difficult to contact	0%	8%	17%	67%	8%
Customers are too proactive	0%	8%	8%	58%	25%

Barriers to Voluntary Compliance:
Governmental Employers' Perspective

Customers require training outside your area of responsibility	0%	17%	50%	25%	8%
TOTAL	1%	19%	28%	33%	19%

EXHIBIT C

IRS CAMPUS FEEDBACK INFORMATION SURVEY RESULTS - (CONT.)

CLIENT KNOWLEDGE					
How proficient do you believe your customers are in dealing with the following subject matters (mark "no opinion" if no experience with item):	VERY PROFICIENT	PROFICIENT	LESS PROFICIENT	NOT PROFICIENT	NO OPINION
Form 941 requirements/form completion	33%	42%	17%	0%	8%
Form 941 C requirements/form completion	33%	33%	0%	25%	8%
Tax Deposit processes/requirements	33%	33%	25%	0%	8%
Form W-2 requirements/reporting	8%	50%	25%	8%	8%
Form W-2c requirements/reporting	8%	50%	25%	8%	8%
Power of Attorney Requirements	17%	50%	8%	17%	8%
Form 1099 Reporting requirements/reporting	8%	42%	17%	8%	25%
Penalty and interest assessment processes	8%	33%	50%	0%	8%
Appeal process for penalties and assessments	8%	33%	17%	17%	25%
Role of service center IRS campus personnel	8%	33%	42%	8%	8%
TOTAL	17%	40%	23%	9%	12%
CUSTOMER AWARENESS					
Please assess problems your customers most frequently cite which impact voluntary employment tax compliance (mark "no opinion if no experience with item):	MAJOR PROBLEM	MINOR PROBLEM	PROBLEM	NOT A PROBLEM	NO OPINION
IRS rules and regulations are too vague	8%	17%	25%	17%	33%
IRS rules and regulations are too complicated	25%	8%	17%	17%	33%
Employers cannot find information required to perform the job	0%	25%	17%	33%	25%
Instructional tools and publications create questions/not answer them	0%	25%	17%	17%	42%
IRS representatives provide conflicting information on routine matters	8%	17%	17%	33%	25%
IRS is not responsive	8%	25%	0%	42%	25%
IRS refund process is cumbersome and slow	0%	8%	25%	33%	33%
IRS is too fragmented	17%	8%	17%	25%	33%
IRS does not understand employer's problems	0%	17%	17%	33%	33%
TOTAL	7%	17%	17%	28%	31%

EXHIBIT C

IRS CAMPUS FEEDBACK INFORMATION SURVEY RESULTS - (CONT.)

What should be done to remove barriers that prevent voluntary customer compliance?

No comments received from the IRS Campus surveys.

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

II. Tribal Advice and Guidance Policy

Raymond C. Etcitty, Project Leader

June 9, 2004

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Introduction[1]

A major obstacle to the ability of tribal governments to implement long-term, self-sustaining economic development projects are the many restrictions within the Indian Tribal Governmental Tax Status Act of 1982 (hereinafter, "the Act"), 25 U.S.C. §7871. The Act contains limiting provisions that prohibit tribal governments from issuing tax-exempt bonds except for the performance of "essential governmental functions." The federal government's failure to understand and accommodate the developmental status of many tribal economies in defining "essential governmental function" actually defeats many tribes' ability to operate as a fully functioning governmental entity on an equal footing with state and local governments. The Act discourages the development and acquisition of the most basic elements of infrastructure taken for granted off the reservation, but so lacking and desperately needed by many tribal communities in virtually every state of the Union.

In order to understand how current federal Indian policies, although well-intended have, in application, fallen short in promoting sound tribal economic development, the following elements are considered herein:

- History of Federal Indian Policy;
- Unique Aspects to Tribal Economic Development; and
- The Indian Tribal Governmental Tax Status Act of 1982 and its Implementation by the Treasury Department and the IRS.

Finally, this report will provide recommendations for addressing the underlying problems of current law that currently frustrates the economic development of tribes; although a Congressional fix may ultimately be the best solution[2].

I. Brief History of Federal Indian Policy

Since our Nation's inception, the federal government's treatment of Indian tribes has run a complex and tumultuous course marred by inconsistencies and extremes. Political historians have grouped these stages into the distinct legal, political, and historical eras described below.[3] Any adequate assessment of the current regime

[1] ACT member Perry Israel did not materially participate in the preparation of this report.

[2] The Project Group interviewed many IRS personnel, tax attorneys, and other officials working for or on behalf of tribal governments. The interviewees consistently maintain that the best solution for the problem facing tribal governments issuing tax-exempt bonds is for a Congress to amend the Act by defining the term "essential governmental functions" or allow tribal governments to issue private activity bonds. The interviewees also generally perceive that IRS officials want either the Treasury Department to develop regulations or desire Congress to amend the Act. Attorneys who work for tribal governments are also somewhat at odds with their recommendations. On one hand, they desire an administrative fix for the term "essential governmental functions" but they are fearful that if the IRS or Treasury Department attempts to administratively fix the problem, then Congress will not amend the Act. But they also are concerned that if Congress attempts to amend the Act, they perceive that the IRS or Treasury Department will not administratively fix the problem.

[3] See *American Indian Law in a Nutshell*, William C. Canby, Jr; Felix S. Cohen's *Handbook of Federal Indian Law*, 1982 Edition.

requires a working knowledge of these eras in order to ensure that prospective goals, policies, and practices achieve common national goals while avoiding exacerbation of past mistakes.

- Establishment of Federal Role - (Colonial times to 1820): This period witnessed the birth of the United States and the establishment of relationships among Indian tribes, European nations, and the United States. The first Congressional acts concerning Indians were passed to regulate commerce between Indians and non-Indians and to manage land exchange issues.

- Indian Removal and Establishment of Reservations - (1820-1887): This was a time when the federal government dealt with the "Indian problem" by removing en masse virtually all tribal peoples further and further westward to established "reservations" in an effort to minimize contact between tribes and non-Indian society as the influx of non-Indian settlers steadily encroached upon ancestral tribal lands.

- Allotment and Assimilation - (1887-1934): This federal policy was championed by proponents of assimilation who believed that Indians would be treated in the most socially responsible and honorable manner by integrating them, not as members of a tribal community but as individuals, into mainstream non-Indian American society. In 1887, Congress approved the General Allotment (Dawes) Act that, for the most part, divided reservation lands into separate parcels that were then allotted to individual Indian males. The allotment policy, while viewed as the most socially responsible plan for dealing with the Indians, also conveniently served to open up vast surpluses of reservation lands for non-Indian settlement. Many Indian reservations that were allotted became (and often remain today) a checkerboard of lands owned by both non-Indians and Indians, with a concomitant hodge-podge of governmental jurisdiction often disputed by both parties.

- Indian Reorganization - (1934-1953): Based on the dismal failure of the allotment policy, which was well documented across the country, Congress attempted to reverse the devastating effects of allotment. Congress placed reservation lands into trust status and enacted a system of federal oversight governing the alienation of these lands. Economic development and education became funding priorities, and tribes were allowed to adopt constitutions and corporations, many of which used federal or state governmental models.

- Termination - (1953-1968): Reorganization of the Indians into cohesive tribal communities was then abandoned in favor of termination. During this era, the federal government "terminated" its official legal recognition of 109 tribes and extinguished the Indian peoples' status as wards of the government. Congress also legislated state control over Indian country in several states by enacting Public Law 280 that provided for state civil and criminal jurisdiction over reservation territory.

- Self-Determination - (1968-present): The civil rights movement of the 1960's led to the re-examination by the federal government of the termination policy. In a 1970 special message to Congress, President Richard M. Nixon called for a new federal policy of "self-determination" for Indian nations. Thereafter, Congress enacted numerous laws that ostensibly supported self-determination and economic development for Indian tribes, including the Indian Tribal Government Tax Status Act of 1982.

"Self-determination" is a federal policy that attempts to promote equitable government-to-government relations between the federal government and Indian tribes, to encourage tribal self-government, and to support the development of tribal economies.[4] This policy has received official support through both Congressional[5] and Presidential actions,[6] as indicated by the following remarks by President Ronald Reagan in his January 24, 1983 American Indian policy statement:

> . . . Instead of fostering and encouraging self-government, [f]ederal policies have by and large inhibited the political and economic development of the tribes. Excessive regulation and self-perpetuating bureaucracy have stifled local decision-making, thwarted Indian control of Indian resources, and promoted dependency rather than self-sufficiency . . . The economics of American Indian reservations are extremely depressed with unemployment rates among the highest of the country. Indian leaders have told this Administration that the development of reservation economies is their number one priority. Growing economies provide jobs, promote self-sufficiency, and provide revenue for essential services . . . Tribes have had limited opportunities to invest in their own economies because often there has been no established resource base for community investment and development. Many reservations lack a developed physical infrastructure including utilities, transportation and other public services . . .The federal government's responsibility should not be used to hinder tribes from taking advantage of economic development opportunities . . . A full economic recovery will unleash the potential strength of this private sector and ensure a vigorous economic climate for development which will benefit not only Indian people, but all other Americans as well. [7]

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[4] See Special Message to the Congress on Indian Affairs issued by Richard M. Nixon, July 8, 1970, and American Indian Policy issued by Ronald Reagan, January 24, 1983; 19 Weekly Comp. Pres. Doc. 98.

[5] See Indian Self-Determination and Education Assistance Act, 25 U.S.C. §§450 et seq.; Indian Child Welfare Act of 1978, 25 U.S.C. §§1901-1963; Indian Financing Act, 25 U.S.C. §§1451 et. seq.; Indian Tribal Governmental Tax Status Act of 1982; 26 U.S.C. §7871; Indian Gaming Regulatory Act of 1988, 25 U.S.C. §§2701-2721; numerous restoration acts for terminated tribes; and various environmental laws that recognize tribal authority.

[6] *American Indian Policy* issued by Ronald Reagan, January 24, 1983; 19 Weekly Comp. Pres. Doc. 98; *Statement on Signing the Indian Self-Determination and Education Assistance Act* issued by Ronald Reagan, October 5, 1988, 24 Weekly Comp. Pres. Doc. 1268; *Statement Reaffirming the Government-to-Government Relationship Between the Federal Government and Indian Tribal Government* issued by George Bush, June 14, 1991, 27 Weekly Comp. Pres. Doc. 783; *Consultation and Coordination with Indian Tribal Governments* issued by William J. Clinton, May 14, 1998, Executive Order 13084; *White House Conference on Building Economic Self-Determination in Indian Communities* issued by William J. Clinton, August 6, 1998, 34 Weekly Comp. Pres. Doc. 1576.

[7] American Indian Policy issued by Ronald Reagan, January 24, 1983; 19 Weekly Comp. Pres. Doc. 98.

(Emphasis added.)

II. Unique Aspects to Tribal Economic Development and the Need for Revenue Generation

Historically, Indian tribes existed as separate and distinct cultures and races from one another. Existing prior to federal, state, and local governments, each tribe developed and maintained its own internal governmental structure, each unique in form, size, land-base, and in the natural resources available to the tribal community. Resources were managed to commensurate with the needs of the tribe.[8] Many of these original tribal governments still exist today, although most have modernized under the pressure of historical and political changes brought by the dominant culture.

Today, there are 562 federally-recognized Indian tribes in the United States.[9] Legal developments in federal Indian law have left tribal governments with certain governmental functions and authority as quasi-sovereign entities that co-exist with federal, state and local governments.

As such, tribal governments have retained some inherent governmental authority, such as the power to raise revenues through taxation,[10] gaming,[11] natural resource development and energy projects,[12] and other economic ventures. They have also regained certain powers once lost, although on a somewhat limited basis. Powers such as criminal and civil jurisdiction over Indian and non-Indians were restricted or extinguished during historical eras limiting tribal sovereignty. Like all governments, tribal governments use their revenues to provide essential governmental services and to promote economic development for their citizens,[13] residents and visitors. In fact, the U.S. Supreme Court in Merrion v. Jicarilla Apache Tribe,[14] held that all residents of Indian country include those persons (Indians and non-Indians, alike) who reside within the exterior boundaries of an Indian reservation "benefit from the provision of police protection and other governmental services, as well as from 'the advantages of a civilized society' that are assured by the existence of tribal government."[15] Further, the Court stated that a tribal government's power to tax is derived, not from its authority as a landowner (e.g. the power to exclude non-Indian from tribal land), but from its

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[8] The sovereign status of tribal governments have been recognized and reaffirmed time and time again by the U.S. Supreme Court. As Chief Justice John Marshall stated "The Indian nations [have always been considered as] distinct, independent political communities, retaining their original natural rights, as the undisputed possessor of soil, from time immemorial . . ." *Worchester v. Georgia*, 31 U.S. (6 Pet.) 505, 559 (1832). See also *U.S. v. Lara*, 204 WL 826057 (U.S.)

[9] Federal Register, 12-05-03; Vol. 68, No. 234.

[10] See *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982); and *Kerr-McGee v. Navajo Tribe*, 417 U.S. 195 (1985).

[11] See Indian Gaming Regulatory Act of 1988, 25 U.S.C. §§2701-2721.

[12] Natural resource development includes coal, natural gas, oil, timber, water, etc.

[13] Citizens of a tribal government are generally members of the Indian tribe. See *Morton v. Mancari*, 417 U.S. 535 (1974), (The U.S. Supreme Court determined that membership in an Indian tribe is a political distinction not racial).

[14] 455 U.S. 130 (1982).

[15] Id. at 138.

authority as a legitimate sovereign to control economic activity within its territorial jurisdiction.

Although the federal government has tried to promote tribal self-determination, the status of tribal governments as "quasi-sovereign" entities has become self-defeating. The primary reason for this predicament is the inherent assumption in federal law that all governments, including tribal governments, possess or can easily acquire the fundamental infrastructure needed to provide basic services to its citizens, residents and visitors. In reality, many tribal governments, still suffering from the impacts of historical federal policies, lack the ability to provide the most basic infrastructure that most U.S. citizens take for granted, such as passable roadways, affordable housing, and the plumbing, electricity and telephone services that come with a modern home.

In fact, most Indian tribes have an economy that is on par with most third world countries.
According to the U.S. Census Bureau, approximately 20% of American Indian households on reservations lack complete plumbing facilities, compared to 1% of all U.S. households. And about 1 in 5 American Indian reservation households disposed of sewage by means other than public sewer, septic tanks, or cesspool. [16]

Moreover, historical and social circumstances have created a climate in which Indian populations living within Indian territories generally have extremely low socio-economic factors, including low educational achievement, high unemployment[17], high poverty[18], and low per capita income.[19] Overall, the lack of adequate infrastructure and low socio-economic factors are unattractive to business development on Indian reservations. And without resolution of these problems, the problems will continue.

Many tribal governments rely on state and federal funds to mitigate these problems. But the funds are insufficient to address the myriad responsibilities facing tribal governments. Similarly, gaming does not provide sufficient funds to meet the needs of all tribal governments. It is a general misconception that all Indian tribes are rich and have gaming, since more than a majority of all Indian tribes are without gaming of any kind.[20] Therefore, if the creation of self-sustaining revenue sources is the goal, tribal governments must be permitted to issue tax-exempt bonds, the bread and butter of most state and local governments treasuries. Unfortunately, the current statutory scheme of the Indian Tribal Governmental Tax Status Act and the implementation of the Act do not allow tribes to issue tax-exempt bonds. It is odd that self-determination has

[16] See Bureau of the Census, Statistical Brief, Housing of American Indian on Reservations – Plumbing (April 1995).
[17] The general U.S. population has unemployment rate of 5.8%, compared to 13.6 percent of the workforce on Indian reservations. See U.S. Census Bureau 2000.
[18] The general U.S. population has a poverty rate of 12.38%, compared to 25.67% for American Indians. See U.S. Census.2000.
[19] The general U.S. population has a per capita income of $21,587.00, compared to $12,893.00 for the American Indians. See U.S. Census 2000.
[20] Total number of federally recognized Indian Tribes: 562. Number of Tribal Governments engaged in gaming (Class II or Class III): 224. See National Indian Gaming Association website, www.indiangaming.org

been a U.S. Presidential policy and a goal of Congress since the late 1960s, but the Indian Tribal Government Tax Status Act as currently written does not fully reflect or advance this federal policy.

III. Indian Tribal Governmental Tax Status Act of 1982 and Its Implementation by the Treasury Department and the IRS

In 1982, Congress passed what was perhaps the most important piece of tax legislation to impact the federal governments treatment of Indian tribes for taxation purposes -- The Indian Tribal Governmental Tax Status Act.[21] Prior to this time, federal law was unclear on how tribal governments, and their subdivisions, were treated for various federal tax purposes.[22]

In keeping with the Self-Determination era of federal Indian policy, the Act attempted to treat tribal governments equally to state and local governments for certain tax purposes. It did not, however, achieve the objective of placing these governments on equal footing to one another.

The Act allowed a deduction from federal income tax for taxes paid to Indian tribes; allowed charitable contributions to tribal governments to be deductible for income, estate and gift tax purposes; and allowed an exemption for tribal governments for various federal excise taxes. But the Act also prohibiting tribes from issuing tax-exempt private activity bonds[23] and limited the ability of tribal governments to issue tax-exempt governmental bonds by allowing them to be issued only for activities that can be classified as "essential governmental functions."

Although the Act itself did not define the term, a Congressional Conference Committee Report stated that "essential governmental functions" includes projects like "schools, streets, and sewers." The report also stated that tribal governments could not issue "private activity bonds" including industrial development bonds. In short, when

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[21] The Indian Tribal Governmental Tax Status Act of 1982, (Title II of Pub. L. No. 97-473, 966 Stat. 2605, 2607-11, as amended by Pub. L. No. 98-21, 97 Stat. 65, 87 [1983-1 CB 510, 511, §1065 of the Tax Reform Act of 1984, 1984-3 (Vol. 1) Cumulative Bulletin 556, made permanent the rules treating Indian Tribal governments, or subdivisions thereof, as states. See also Revenue Procedure 86-17 and Revenue Ruling 86-44. The term "Indian Tribal government" is defined under IRC§ 7701(a)(40), as amended, to mean the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, that is determined by the Secretary of the Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions. This definition is used to comprise the federally recognized list as determined by the Bureau of Indian Affairs. The Indian Tribal Governmental Tax Status Act of 1982, (Title II of Pub. L. No. 97-473, 966 Stat. 2605, 2607-11, as amended by Pub. L. No. 98-21, 97 Stat. 65, 87 [1983-1 CB 510, 511]).

[22] See Revenue Ruling 67-284 (Indian tribes are not a taxable entity.); Revenue Ruling 81-295 (Federally-chartered corporations wholly owned by an Indian tribe is not a taxable entity.); and Revenue Ruling 68-231 (Bonds issued by tribal governments would not be treated similar to bonds issued by state governments.)

[23] The Act applies the following requirements for special manufacturing facility bonds: 95% of the bond proceeds must be used to finance property that is acquired, constructed or improved by the tribal government, the property must be of a type that is subject to depreciation and part of a manufacturing facility, the property must be on Indian lands that must be held in trust by the United States at least five years prior to the issuance of the bond and be held at all times the bonds are outstanding, and an employment test is used. See IRC §787 (C)(3).

Congress prohibited Indian tribes from issuing private activity bonds and limited tribes from issuing governmental bonds for "essential governmental functions," Congress simply failed to follow the clearly stated federal policy of tribal self-determination.

Governmental bonds[24] and private activity bonds[25] would be a vital financial tool for tribal governments because these bonds allow the government to secure capital for the building of infrastructure, which, in turn, encourages economic development within Indian reservations.

In 1984, the Treasury Department developed proposed/temporary regulations, Treasury Regulation §305.7871-1(d)(1984), T.D. 7952, 1984-1 C.B. 276), to define the term "essential governmental function." The regulations defined "essential governmental functions" as a type of function that is:

a) Eligible for funding under the Snyder Act (25 U.S.C. §13)[26];
b) Eligible for grants or contracts under Indian Self-Determination Act (25 U.S. §450(f), (g), and (h)); or
c) An essential governmental function under I.R.C. § 115 and the regulations thereunder when conducted by a state (or political subdivision, thereof).

The Snyder Act and the Indian Self-Determination Act are congressional acts that allow the federal government to provide funds for tribal self-governance and self-determination. When the Regulations incorporating activities that could fall under the Snyder Act and Indian Self-Determination Act, the Regulations in effect expanded the activities that tribal governments could tax-exempt finance which appear to go beyond the intent of Congress. On one hand, the regulations do not appear out of character with federal policy towards Indian tribes and the need to develop economic development. On the other hand, the Regulations did to not give much weight to the Conference Report and its examples of what is an "essential governmental function." It has been

[24] Governmental bonds are obligations issued by a governmental unit (or other entity) to finance governmental operations. A local government issues these bonds for its own purposes. For example, a county can issue bonds and expect to use the proceeds to:
- build or renovate a building which the county itself will use,
- build, repair and/or maintain schools and roads,
- build and operate a county-owned power plant or sewage treatment facility.

Two distinguishing characteristics of governmental bonds are that the bond proceeds:
- will be USED by the governmental entity for its own purposes, and
- the bond-financed property will be OWNED by the governmental unit.

See IRS Module B, *Introduction to Federal Taxation of Municipal Bonds*, page B-3.

[25] Generally, private activity bonds are bonds issued by a governmental unit (or related entity):
- the proceeds of which will be used by an entity OTHER THAN a governmental unit, AND
- the debt service of which will be paid from private payments.

See IRS Module B, *Introduction to Federal Taxation of Municipal Bonds*, page B-4.

[26] The Snyder Act authorizes the Bureau of Indian Affairs to make federal expenditures to assist Indian tribes for such purposes as "industrial assistance and advancement and general administration of Indian property."

speculated that the Regulations were drafted based on comments received from tribal governments.[27]

After the regulations were published, seven tribal bonds were issued that totaled under $300 million.[28] Six of the seven bonds were for off-reservation projects that involved "leverage buy-outs" of commercial and industrial facilities. The only bond issued for an on-reservation project was to construct a health clinic. The tribal bonds that were issued for off-reservation commercial and industrial facilities received significant negative public and media attention[29]. In reaction to the public scrutiny following the tribal bond offerings for off-reservation projects, Congress in 1987 amended the Indian Tribal Government Tax Status Act. The Report of the House Committee on its reason for amending the Act states:

> The committee is extremely concerned about recent reports of Indian tribal governments issuing tax-exempt bonds for what are substantively interests in commercial and industrial enterprise.[30]
> . . .
>
> [W]ith respect to bonds issued by Indian tribal governments, the term essential governmental function does not include any governmental function that is not customarily performed (and financed with governmental tax-exempt bonds) by States and local governments with general taxing powers. For example, issuance of bonds to finance commercial or industrial facilities (e.g. private rental housing, cement factories, or mirror facilities) which bonds technically may not be private activity bonds is not included within the scope of the essential governmental function exception.

The House Report concluded with a harsh remark of the Treasury Department regulations:

> Additionally, the committee wishes to stress that only those activities that are customarily financed with governmental bonds (e.g. schools, roads, governmental buildings, etc.) are intended to be within the scope of this exception, notwithstanding that isolated instances of a State or local government issuing bonds for another activity may occur. Further, the fact that the Bureau of Indian Affairs may provide Federal assistance for Indian tribal governments to engage in commercial and industrial ventures as tribal governments activities is not intended to be determinative for purposes of the Internal Revenue Code.

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[27] See Ellen P. Aprill, *Tribal Bonds: Indian Sovereignty and Tax Legislation Process*, 46 Admin. L. Rev. 333 (1994). See also John E. Theberge and Diana A. Imholtz, *Tax-Exempt Financing Involving Indian Tribal Governments*, The Exempt Organization Tax Review, August 2003, Vol 41, No. 2; and Kathleen M. Nilles, *Tribal Bondage: A Brief History of the Tax-Exempt Financing Rules Applicable to Tribes*, prepared for "Tribal Bonds: A Unique Case" at The Inaugural National Native American Tribal Finance Conference, February 18th-20th, 2004, The Spa Resort & Casino, Palm Springs, California.

[28] See Aprill, ,at 33.

[29] See Matthew Schifin, "Smoke Signals" Forbes (June 15, 1987) at 42.

[30] H.R. Rep. No. 391at 1139.

(Any existing Treasury Department regulations that my infer a contrary result are to be treated as invalid.)[31]

(Emphasis added.)

Unfortunately, the amendment did little to resolve the problem, since it did not clearly define the term "essential governmental functions." Instead, the amendment added language stating that the term "essential governmental functions" shall not include any function that is not customarily performed by State and local government with general taxing powers. Congress' action in effect overturned the Regulations.

Since the 1987 amendments to the Act, there have not been any regulations defining the term "essential governmental functions." Moreover, the IRS also has not provided any guidance or instructions to tribal governments on what is or what is not an "essential governmental function." [32] But on November 22, 2002, the IRS issued Field Service Advice 20024712 (hereinafter "FSA") to address an issue of whether the construction and operation of the Golf Course by an Indian tribe is an "essential governmental function" within the meaning of §7871(e). The FSA examined the legislative history of the Act and the events surrounding the 1987 amendments. And the FSA also added a type of subjective balancing test in which the purpose of the activity is examined to determine whether the activity is more commercial or more governmental, in nature and purpose. This standard is very much subjective without further guidance and information. The FSA concluded, although there were 2,645 publically owned, municipal golf course in the United States, the commercial nature of the golf course owned by an Indian tribe cause it to be other than an essential function within the meaning of §7871(e).

IV. Proposed Resolution and How to Achieve It

The IRS should take the following steps to develop guidance and instruction to tribal governments for the term "essential governmental function:

- The IRS should request the Treasury Department to develop regulations to define "essential governmental functions" under §7871(e);
- The IRS should clarify that the "essential governmental function" under §7871(e), be construed in accordance with the term "essential governmental function" under §115.
- Withdraw FSA 200247012 and suspend issuance of any other non-precedential Guidance.

[31] H.R. Rep. No. 391, 100th Cong., 1st Sess. 1139 (1987).
[32] The Project Group examined the available material on the IRS website and publications that the IRS provides for the public.

The IRS can't develop clear guidance and advice for the term "essential governmental functions" if there are no regulations. There is hesitation by the IRS and the Treasury Department to do anything but wait for a congressional fix.

A. The IRS should request the Treasury Department to develop regulations to define the term "essential governmental functions" under Section 7871(e).

As stated above, the Treasury Department has not developed any regulations since 1984 that defines the term "essential governmental functions." Short of Congressional legislation that fully recognizes tribal government as having equal federal tax treatment with state and local governments, a Treasury regulation defining the "essential governmental function" test under §7871(e) is the best solution. But in order develop such regulations; the Group recommends that regulation should balance the following:

- The legislative history of the Act
- The federal policy of self-determination.

The history of the Treasury Department and IRS with the term "essential governmental functions" demonstrates a myopic vision. When Treasury Department originally developed its regulations to define "essential governmental functions," it appears that the regulations were drafted based on tribal government recommendations with little regard to the legislative history of the Act[33]. This decision to develop the regulation without examining the legislative history of the Act caused a Congressional backlash that resulted in the 1987 amendments to the Act. In addition, the manner by which FSA 20024712 was drafted also appears to be too one-sided.

The Group believes that the FSA relied solely upon the confusing legislative history of the Act and did not relying on any tribal policy or tribal input to develop the advice. The legislative history should not be read as imposing an additional test (i.e., "no 'commercial' activity") on the activities conducted by tribal governments. Therefore, in an attempt to provide some balance in draft subsequent regulations, the regulations should attempt to balance two sources of information – the legislative history of the Act, and the federal policy of self-determination, which is currently being implemented through the development of IRS's proposed tribal consultation policy. These regulations should be drafted with the assistance of tribal governmental representatives who are familiar with reservation communities and the unique revenue-generating opportunities found across Indian Country.

B. The IRS should clarify that the "essential governmental function" under §7871(e), be construed in accordance with the term "essential governmental function" under §115.

Under §115, activities that make or save money for the state can be "essential governmental functions" so long as the income generated from the activity is used for a

[33] See Aprill, Bonds.

governmental purpose[34]. The Group recommends avoiding giving inappropriate weight to the legislative history's mention of "commercial or industrial facilities" in construing §7871(e). Congress did not incorporate the phrase "commercial or industrial" facilities into the statutory language in §7871(e). Therefore, IRS guidance should focus on clarifying the words of the statute – "not customarily performed by a state or local government with taxing power," using §115.

C. Withdraw FSA 200247012 and Suspend Issuance of any other Non-precedential Guidance.

FSA 200247012 has muddied the waters. It is premised on an incorrect assumption of law – i.e., that "revenue-generating activities" conducted by a tribal government are not "essential governmental" functions. In addition to giving far too much weight to references in the committee reports to the words "industrial" and "commercial," the FSA imports a grossly subjective element into the determination of whether a particular tribal activity constitutes an essential government function. For example, the FSA suggests that "the probable role of the Golf Course in the community contrasts with that of the more typical golf course developed by a state or local government." Until the Treasury Department or IRS issues clear public guidance under §7871(e), the IRS should not be permitted to use the examination process to make new law in this area.

D. Suspend Any New Compliance Initiatives Applicable to Tribal Bonds Until After Published Guidance is Issued.

It would be inappropriate at this time for the IRS to implement any new compliance initiatives aimed at tribal bond issuances. IRS agents simply do not have adequate guidance from the IRS Chief Counsel and Treasury Department to measure compliance with the "essential governmental function" test at this time. If informal guidance is issued, it should be make explicitly labeled as interim safe harbor guidance.

V. Summation

How can tribal governments develop sustainable economies that produce recurring revenues needed to provide the infrastructure for their citizens, residents and visitors, when tribal governments have their hands tied behind their back? Since the 1987 amendments, the Treasury Department hasn't published any further proposed regulations to define the term "essential governmental function." Without any guidance

[34] See, *e.g.*, Revenue Ruling 90-74 1990-2 C.B. 34 (government liability pools, which met the obligations of political subdivisions to protect the financial integrity, fulfilled an essential governmental function); Revenue Ruling 77-261, 1977-2 C.B. 45 (an investment fund established by state constituted an essential governmental function). In Private Letter Ruling 200116009 (April 23, 2001), the IRS ruled that §115 excluded the income of a nonprofit corporation formed by a city to assist it in financing, acquiring, constructing and operating a convention center hotel. A key premise underlying the ruling was the IRS concluded that the operation of the hotel was an essential governmental function because it allowed the city to lessen the deficit associated with the convention center's operation.

or instruction, tribal governments and the public are left with the tedious burden of requesting separate private letter ruling to determine whether their proposed project is something that state or local governments with taxing powers “customarily” perform and whether the activity is more governmental or commercial in nature or purpose. Tribal governments and the IRS are also left to attempt to discern what Congress meant in the legislative history when it referred to “commercial or industrial facilities.” Overall, the unclear definition of “essential governmental functions” leaves tribal government with the impossible task of providing governmental services to their citizens, resident, and visitors without any real ability to utilize tax-exempt, one of the biggest financial tool of nearly every state and local governments.

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

III. EP Operational Guidance

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June 9, 2004

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I. EXECUTIVE SUMMARY

Over the years, the Internal Revenue Service TE/GE Division (TE/GE) has provided much guidance to employers regarding the proper operation of their retirement plans. We, the EP Operational Guidance project team members, recommend that TE/GE provide even more such guidance, especially basic information, such as checklists, useful to small employers.

We also recommend that TE/GE publish comprehensive resource guides, in plain English, on the TE/GE website, for the most common plans involving salary deferrals: 401(k) plans and governmental 403(b) tax-sheltered annuity programs. Rough outlines of such guides are attached as Exhibits G and H, and their component checklists are attached as Exhibits D, E, F, I, J, and K. The guides, and their component checklists, are intended to educate employers regarding best practices, common mistakes, and general responsibilities, so that employers can better operate their plans in compliance with the plan documents and applicable law.

We believe that the time is right for these resource guides. As the 401(k) regulations are finalized and the 403(b) proposed regulations come out, the 401(k) and 403(b) compliance guides should be excellent practical tools for employers.

We further recommend that, if the resource guides are well received by employers, TE/GE provide similar guides for plan participants, so that participants can more easily monitor whether the plans are being properly operated.

Finally, we recommend that TE/GE periodically ask the employee-plans members of ACT to provide input on plan-operational guidance that is under development by TE/GE.

II. ANALYSIS

Employer maintenance of a retirement plan has two general aspects: the plan document and plan operation. The plan document is often the easier of the two; an employer generally has no trouble obtaining a properly-written document from a retirement-plan provider, typically the financial institution that holds the retirement-plan funds. Operation of the plan in compliance with the plan document and with applicable law is where most employers have trouble. Plans with employee salary deferrals, such as 401(k) plans and 403(b) tax-sheltered annuity programs, seem to have an especially-high incidence of plan-operation trouble.

Overall, an abundance of guidance is available to help employers operate their plans properly. Guidance is available from the retirement-plan providers themselves, from professional advisors such as attorneys and consultants, from trade associations and

employer groups, and from the federal government, particularly the U.S. Department of Labor and the Internal Revenue Service.

Unfortunately, much of the currently available plan-operation guidance is not very useful to the typical small employer. Much of the guidance is written for professionals or people who understand retirement-plan fundamentals. Many small employers simply do not understand the guidance, and will not take the time to understand it. As a result, we see a crucial need for very basic, easy-to-understand guidance for employers. A key component of such guidance would be checklists, because checklists are often better than standard narrative text at focusing a reader's attention on what needs to be done.

Recently, TE/GE, through the efforts of its Customer Education and Outreach Division (CE&O), headed by Mark O'Donnell, has been attempting to fill this need. CE&O has been providing employers, particularly those maintaining IRA-based plans, with some very basic retirement-plan operational guidance. Such guidance is characterized as "soft guidance," in contrast to the "hard guidance" (and technical detail) of regulations and Revenue Rulings.

Since beginning the EP Operational Guidance project in August 2003, we have provided input to CE&O in this effort. We encourage TE/GE to continue issuing such guidance. And we recommend that TE/GE go so far as to prepare and disseminate, especially through the TE/GE Internet website, in plain English, comprehensive resource guides for the most common retirement plans involving employee salary deferrals: 401(k) plans and 403(b) tax-sheltered annuity programs. We have prepared the rough beginnings of such guides.

Outgrowth of this Project from Prior ACT Projects

We embarked upon this EP Operational Guidance Project as a natural follow-up to two prior ACT projects:

(1) In the Small Business Access and Compliance Project Group Report dated June 21, 2002, the ACT made a number of recommendations regarding TE/GE customer education materials. One of the specific recommendations was that TE/GE develop employer plan compliance checklists. Another was that TE/GE develop a "how-to" manual for employers to learn the basics of establishing a retirement plan and properly administering it from year to year. A third was that TE/GE encourage third-party vendors and plan sponsors to develop plan-operation manuals.

(2) In the TE/ GE Education and Outreach Project Group Report dated June 21, 2002, the ACT made recommendations for education and outreach projects for the three components of TE/GE (EO, EP, and FSLG/ITG/TEB). That project

assessed customer needs, reviewed existing TE/GE products and distribution methods, and recommended future projects. The ACT explored (a) the informational materials that TE/GE made available to its customers, (b) TE/GE Customer Account Services contacts with customers through the call site, (c) additional materials that would be useful to TE/GE customers, and (d) methods for TE/GE to disseminate useful information to its customers. The ACT concluded that (a) the Internet should be a critical component of any TE/GE educational efforts, (b) "primer" materials were a missing component, and (c) TE/GE should consider both primary and secondary distribution methods for its materials.

In this EP Operational Guidance Report, we take the prior suggestions to the next level – we recommend that TE/GE publish resource guides for the most common non-IRA-based retirement plans: 401(k) plans, and 403(b) plans. We also make recommendations on operational guidance for IRA-based plans, such as simplified employee pensions (SEPs), salary-reduction SEPs (SAR-SEPs), and SIMPLE IRAs.

The resource guides recommended in this EP Operational Guidance Report are not the kind of plan-operation manuals that the ACT recommended in its Small Business Access and Compliance Project Group Report dated June 21, 2002. Such manuals would undoubtedly be useful. Because of substantial differences between the retirement-plan operations of one employer to another, however, we believe that the drafting of model plan-operation manuals would be more difficult than the drafting of the resource guides recommended in this EP Operational Guidance Report. Perhaps the resource guides can someday become the foundation for model plan-operation manuals.

Project Team Activities

Most of our project activities related to the operational guidance materials described in this report. During each working session, we spent a considerable amount of time on the guidance materials themselves, sometimes by ourselves and sometimes in meetings with TE/GE personnel.

In addition, however, during each meeting, we spent at least some time with Mark O'Donnell and other TE/GE and Treasury personnel discussing their projects currently under way. This helped us put our project in the proper context. More importantly, however, it gave the TE/GE and Treasury personnel an opportunity to preview projects with us that were still in the developmental stages, obtaining suggestions for modification prior to public review.

In one instance, an ACT member invited a marketing executive to an afternoon ACT session to discuss the development of worksheets for small employers with a SEP

or SIMPLE IRA program. The executive's background was in the retail or smallest-employer retirement-plan market. The meeting provided the Treasury and TE/GE staff some insight into whether financial institutions would view such operational guidance materials as helpful to the institutions' clients and whether the institutions would be interested in providing such materials to their clients.

Reasons for Focus on Operational Guidance

Our focus on operational guidance reflects certain opinions that we hold:

(1) Almost all employers that maintain retirement plans want to operate their plans in compliance with the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA).

(2) The law governing employer-sponsored plans is extraordinarily complex and detailed, which presents mutual challenges for TE/GE and employers.

(3) Small employers may be unwilling to purchase (or unable to afford) extensive services from professional advisors and third-party vendors of retirement plans and, accordingly, need more assistance from TE/GE.

(4) Often the retirement plan vendor's point-of-sale person who assists a small employer in implementing a plan lacks the technical expertise to properly educate the employer regarding its responsibilities.

(5) The more knowledgeable an employer is regarding retirement-plan operational requirements, the better the employer can monitor whether it is obtaining all the services it needs from its retirement plan providers and third-party administrators (TPAs).

(6) Existing retirement-plan operational guidance has gaps, especially at simpler, easier-to-understand levels.

(7) At a future time, after a reasonable amount of plan operational guidance is provided to employers, similar guidance should be provided to plan participants, because educated participants can help monitor whether their employers (and TPAs) are properly operating the plan.

Issues in Preparing Operational Guidance

As we worked on our project, two of the issues we considered were:

What is the objective?
and
Does a lack of technical specificity make a publication misleading?

What Is the Objective?

We believe that, in issuing retirement-plan operation guidance, the primary objective of TE/GE should be to provide basic, usable information to employers, especially small employers that typically do not obtain extensive services from professional advisors. Such an objective is consistent with other guidance already provided by TE/GE, such as the "Retirement Plan Life Cycle" guidance. Such prior guidance was intended to help small businesses understand the benefits and responsibilities of retirement plans. It was also intended to encourage a greater percentage of small employers to establish retirement plans. and to adopt the right kinds of retirement plans for their businesses.

Traditionally, TE/GE has directed a great deal of its guidance towards experienced tax professionals. In some respects, this is the easiest audience for whom to draft guidance. The drafters need not be concerned about the use of technical language, references to rulings, regulations, and other publications, or the inclusion of a great amount of detail.

In drafting educational material to be used by employers rather than tax professionals, however, the technical detail is a serious obstacle to communication. To be effective, the guidance directed at employers should avoid using technical language as much as possible.

Indeed, for a large segment of employers, the ultimate objective of soft guidance should not be to teach the employers the law but rather to assist employers in identifying potential problems and asking good questions of their retirement plan service providers. Stated another way, employers can more easily be directed to identify the results of proper operation than to understand the law that governs proper operation. For example, asking an employer whether its SIMPLE IRA is its only retirement plan is a very effective way of assisting an employer in determining whether it is following the law.

Does a Lack of Technical Specificity Make a Publication Misleading?

Some TE/GE staff voiced concerns that the omission of technical details and technical requirements might make plan-operation guidance misleading, thereby hindering compliance. We believe that, at least with regard to guidance published on the IRS website, these concerns can be effectively addressed through the use of

hyperlinks that direct a reader to more-technical information located elsewhere on the website. Well-drafted, plain-English guidance need not be misleading.

With regard to hard-copy printed material, the omission of technical details is not as easy to address. We suggest that TE/GE make frequent use of terms such as "generally" or "may," to signal the reader that additional inquiry would be appropriate. And we suggest that, whenever reasonably possible, in drafting checklists, TE/GE follow each question with an explanation or summary of the requirement that was the basis of the question.

Guidance for Participants

Most of the educational guidance published by the IRS over the past few years has been targeted to tax practitioners, and more recently, to employers who sponsor plans. The IRS should consider whether future educational material should be directed to plan participants. Although plan participants are not involved or responsible for an employer's compliance with the law, they are the ultimate stake holders. Educated employees can be an effective force in furthering compliance if they are aware of their rights as participants.

With regard to IRA-based plans, the need for educational material for employees is more acute. As owners of the IRAs, with the concomitant responsibility for complying with the tax rules applicable to IRAs, employees need to monitor the contribution requirements, the distribution rules, the penalties for taking premature distributions, and the like.

Readability

Any modern discussion concerning improved communications inevitably leads to a discussion regarding "readability." This term most often refers to various mathematical formulae used to measure the ease with which a particular document can be read. Many word processing software programs include variations of readability formulae as part of their grammar and spelling checking function.

We considered whether soft guidance produced by the Service should satisfy a predetermined readability standard. After research and discussion, we determined that strict adherence to readability standards would not be productive. Most readily accessible readability formulae simply count the number of words per sentence and the number of multi-syllable words used within a document. The formulae do not measure whether a document is comprehensible or take into account the complexity of the subject matter.

Guidance regarding tax matters is inherently complex. While the use of shorter sentences and simpler language is a good goal, these characteristics alone will not assure that the Service's guidance accomplishes its primary objective of educating taxpayers. We recommend that the Service continue to focus its attention on avoiding

technical terms and terms of art in its soft guidance. We must acknowledge that much of the soft guidance produced by the Service during the past year has been quite successful in providing plain English explanations of rather complex retirement plan matters.

Distribution Channels

TE/GE has recently been prolific in producing and publishing high-quality educational material with regard to employer-sponsored retirement plans. These materials are most easily accessed through the IRS website. Much of the material found on the website has also been produced in the form of brochures and pamphlets. A challenge facing TE/GE is developing distribution channels to assure that these publications reach the appropriate audience.

We applaud TE/GE on its beginning efforts to create an e-mail listserv for employer sponsors of retirement plans. Such a listserv would be a logical method of informing small employers where to find (and even linking them directly to) plan-operational guidance on the IRS website.

We also recommend that TE/GE Service have the following organizations on its list of potential partners:

BenefitsLink - a website serving the employee benefits community

Small Business Administration

United States Chamber of Commerce

National Association of Enrolled Agents

American Institute of Certified Public Accountants

American Bar Association Section of Taxation

III. PRINCIPLES OF OPERATIONAL GUIDANCE

We recommend that, in issuing soft guidance to employers regarding the operation of their retirement plans in compliance with the plan terms and applicable tax-qualification rules, TE/GE follow certain principles:

(1) ***Multiple levels of educational materials***, Entry-level materials should be the simplest. Small employers need basic educational materials, written in very plain English. The most basic material should involve checklists.

(2) ***Integration among the levels***. As employers seek further guidance beyond entry-level information, they should be directed to more detailed-level materials. The final level should be the statute, regulations, or other source material.

(3) ***Primarily Internet-based***. The guidance should be written primarily for posting on the TE/GE website to facilitate the linkage between the different levels.

(4) ***Diagnostic Orientation.*** Basic guidance should not be designed to make employers experts on the law. Rather, it should be designed to identify potential compliance problems and direct the employer to where assistance is available, such as to the third-party administrator.

(5) ***Employers as Consumers.*** Guidance, especially in the form of a "who does what" checklist, can help employers understand the responsibilities of their retirement-plan service providers. Few employers operate their plans without outside assistance from such service providers. Unfortunately, without a basic understanding of plan operational issues, employers are not capable of evaluating the quality of assistance that they are receiving from service providers.

IV. OPERATIONAL GUIDANCE FOR PARTICULAR TYPES OF PLANS

Different kinds of retirement plans require different kinds of operational guidance. We recommend that TE/GE focus first on IRA-based retirement plans and plans with employee salary deferrals, namely, 401(k) plans, 403(b) plans, and 457(b) plans maintained by government entities.

a. Operational Guidance Regarding IRA-Based Plans

Employer-sponsored IRAs, including SEPs, SARSEPs, and SIMPLE IRAs, are an important component of the private pension system. In September 2003, the Investment Company Institute reported on its survey of member-financial institutions regarding the use of SIMPLE IRAs. It found that during the 2002 calendar year, the number of SIMPLE IRA plans increased 11%, the number participants rose 12%, and SIMPLE IRA assets invested in mutual funds increased about 19%. It concluded that the SIMPLE IRA continues to be most popular among employers with 10 or fewer employees.[1]

[1] http://www.ici.org/stats/mf/03__simple_stats2.html#TopOfPage. The Investment Company Institute (ICI) is the national association of the U.S. investment company industry. Founded in 1940, its membership includes approximately 8,595 mutual funds, 612 closed-end funds, 124 exchange-traded funds, and five sponsors of unit

SEPS and SIMPLE IRAs present a particularly difficult compliance challenge. They are at once both individual retirement accounts and employer-sponsored retirement plans. On the IRA level, the IRA owner and the financial institution acting as custodian or trustee share responsibility for the establishment and maintenance of the IRA. When amendments are required, the financial institution acting as custodian or trustee must see that all IRAs are timely amended by providing IRA owners with the appropriate new traditional or SIMPLE IRA agreement and amended disclosure statement.[2]

The employer is responsible for establishing and maintaining the plan by adopting and keeping current the appropriate plan document. More often than not, the document is a model plan offered by the Internal Revenue Service. The financial institution that acts as the IRA custodian or trustee may or may not have direct involvement with the employer in establishing the plan. Additionally, given the "self-help" nature of the SEP and SIMPLE IRA, the employer-sponsor may not be as likely to have professional advisers assisting with compliance matters.

We began our work by editing a SEP checklist (Exhibit A), a SARSEP checklist (Exhibit B), and a SIMPLE IRA checklist (Exhibit C), all of which were prepared by TE/GE as part of its "Retirement Plan Life Cycle" project. These checklists are included in a "Plan Information Packet" for IRA-based retirement plan sponsors. An employer can use the appropriate checklist to conduct a self-audit of its plan. The checklists will not uncover every possible plan error. (For example, the checklists do not ask questions about required amendments.) However, the checklists identify typical operational failures for the relevant type of plan.

The questions on the checklists have been structured to elicit "yes" or "no" answers. If a plan is being operated correctly, all the questions on the checklist will be answered affirmatively. Each checklist concludes with the following statement:

> If you answered "No" to any of the above questions, you may have made a mistake in operating your plan. Many mistakes can be corrected easily and without penalty. We suggest that you contact your benefits professional. For more information, visit the IRS Retirement Plans web page at www.irs.gov/ep or call IRS TE/GE Customer Account Services toll-free at 1-877-829-5500.

TE/GE may want to consider adding caveats to all soft guidance, stating that this such material is intended to provide the reader with basic, general information, and

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investment trusts. Its mutual fund members represent 86.6 million individual shareholders and manage approximately $7.6 trillion in investor assets.

[2] "SEP/SIMPLE Amendments, A Reminder" Greg Tacik, Bankers Systems, Inc. 2002, http://www.complianceheadquarters.com/IRA/IRA_Articles/sep_simple_amendments.html.

encouraging plan sponsors to refer to the law and regulations or professional advice for further guidance. We believe that TE/GE has very creatively and effectively structured these checklists in a fashion that minimizes the risk of them being misleading or inaccurate.

The checklists for employer-sponsored IRAs were used as part of a pilot program to distribute information directly to IRA-based retirement plan sponsors. The IRS identified probable IRA-based plan sponsors, using employee and employer tax information. In November 2003, these taxpayers were sent a package of information, including a contact letter, the plan checklist described above, a feedback postcard, and a copy of Publication 4224 entitled "Retirement Plan Correction Programs." TE/GE received very favorable responses from taxpayers who received the package of information.

Unfortunately, a direct mailing to IRA-based plan sponsors on a wide scale would be prohibitively expensive. We encourage TE/GE to disseminate materials through "partners" as much as possible. The IRS has already identified several potential partners for assistance in making soft contacts with sponsors of IRA-based plans:

National Association of Personal Financial Advisers

National Association of Tax Professionals

National Association of Enrolled Agents

Securities Industry Association

Investment Company Institute

American Payroll Association

We recommend that TE/GE add the following organizations to its list of potential partners for dissemination of materials regarding IRA-based plans:

BenefitsLink

The Certified Financial Planners Board of Standards

Bank Administration Institute

American Institute of Certified Public Accountants

American Bar Association Section of Taxation

TE/GE should also consider partnering with organizations that support small business in ways other than through tax and financial services. For example, the

National Federation of Independent Business (NFIB) represents over 600,000 small-businesses, 55% of whom have five or fewer employees and 72% of whom have 10 or fewer employees. These small businesses are the most likely employers to sponsor IRA-based retirement plans. The NFIB maintains a special website, nfib.smallbusiness.com, to allow employers to share advice and educational material. This website should be a useful means of publicizing and distributing the checklists and other IRA-based plan materials.

One danger of using partners to disseminate educational material is that the sources of distribution are no longer in the control of TE/GE. Consequently, there is no way of removing from circulation any material that is no longer viable due to changes in law or regulations. For this reason, TE/GE may wish to limit the number of partners with which it works and may wish to establish protocols with those partners for updating material. Additionally, TE/GE should date all material and invite readers to check the Internal Revenue Service website for more current information.

b. Operational Guidance Regarding 401(k) Plans

Salary reduction plans, such as 401(k) plans and 403(b) tax-sheltered annuity programs, are the primary type of defined-contribution plan. These types of plans are reported by nearly 27.7% of all workers as their primary retirement plans. The average contribution rate by participants is 7.4% of compensation.[3]

Unlike the IRS model documents available for IRA-based retirement plans, no IRS-published model documents currently exist for 401(k) plans. Moreover, the requirements of the Internal Revenue Code with respect to 401(k) plans are substantially more complex than the requirements of IRA-based retirement plans. Consequently, these plans are typically established by employers with the assistance of attorneys, accountants, benefit consultants or investment institutions. Additionally, many small employers rely on outside service providers for ongoing administration of 401(k) plans.

Presently, a number of projects aimed at providing additional guidance for 401(k) plan sponsors are underway within TE/GE. Among these projects is an effort to accumulate, in a single place, various 401(k) plan compliance materials.

Building on TE/GE's efforts regarding the IRA-based checklists, we drafted a 401(k) plan checklists. A long-form version is Exhibit D. This checklist is not intended to provide comprehensive guidance, but simply to alert an employer to basic operational requirements.

Responding to the long-form version, a TE/GE staff person drafted a short-form checklist that is Exhibit E., entitled "Annual 401(k) Check-up: *Is Your Plan Being*

[3] "An Analysis of the Retirement Plan and Pension Topical Module of the SIPP, Craig Copeland, Employee Benefits Research Institute Issue Brief, May 2002.

Operated Properly?" The purpose of the shorter checklist is to make it more inviting to potential readers. We believe there are uses for both checklists.

We also drafted a "Who Does What" 401(k) plan checklist that is found in Exhibit F. It is designed to assist an employer in confirming that all essential administrative functions are being handled by someone, either the employer or a third-party administrator or someone else.

Finally, in Exhibit G, we began a very rough draft of an outline for a comprehensive resource guide for employers that maintain 401(k) plans. This guide is intended to provide more detailed, yet non-technical, information regarding retirement-plan administration. We recommend that TE/GE finish the job that we started and that TE/GE put the finished product on the IRS website, with hyperlinks to appropriate sections of the guide from the checklists described above.

c. Operational Guidance Regarding 403(b) Plans

In Exhibit H, we also began a very rough draft of an outline for a comprehensive resource guide for governmental employers that maintain 403(b) tax-sheltered annuity programs. We likewise recommend that TE/GE finish the job that we started and that TE/GE put the finished product on the IRS website.

In the 403(b) guide draft, we include suggestions for sections on some of the most common problems that occur in 403(b) programs. Additional sections could be added in the future if this guide proves to be useful. We would not expect that such additional sections would be added until after the section 403(b) regulations are published.

Component parts of the 403(b) guide (or stand-alone items) would consist of three sets of checklists. The first checklist, Exhibit I, is directed at elementary and secondary public schools. The second checklist, Exhibit J, is an annual "check-up" for governmental-employer 403(b) programs and is designed to focus on a single year's changes. The third checklist, Exhibit K, is a "Who Does What" to help governmental employers determine who is responsible for various administrative actions.

Not part of the 403(b) guide, because of its focus on governmental employers, but nevertheless a product of our labors is a fourth checklist, Exhibit L, for nongovernmental employers that maintain 403(b) plans. This checklist is of the "Who Does What" kind.

d. Operational Guidance Regarding Governmental 457(b) Plans

We also drafted a checklist for 457(b) programs sponsored by governmental employers for their employees (and, in some cases, independent contractors). A 457(b) resource guide for such plans could be prepared and patterned after the 403(b)

resource guide for governmental employers. The number of 457(b) plans appears to be increasing in recent years, which supports the usefulness of such a guide.

e. Operational Guidance Regarding Other Kinds of Retirement Plans

We recommend that TE/GE consider whether similar materials should be prepared for other kinds/types of plans. Nevertheless, the prioritization may vary considerably, depending upon the type of plan. Although much of the attention on qualified plans has focused on 401(k) plans, which may include a profit-sharing feature as part of the total plan design, the smallest employers may often use a form of profit-sharing plan without any 401(k) feature. These employers are also candidates for SEP and SIMPLE IRA programs. We believe that the appended materials should be modified for use by these employers.

Other types of retirement plans appear to be less of a priority. The major considerations would be the relative complication of plan design and applicable Code rules and the number of concerned employers and affected employees.

Other types of qualified plans are defined-benefit pension plans, money-purchase pension plans, and target-benefit pension plans. The complex funding and tax deduction rules provide a primary concern for employers that sponsor defined-benefit pension plans. Such plans sometimes provide a different benefit formula for different groups of employees or, where the formula has changed over the years, for different periods of participation. Target-benefit pension plans are also complicated to explain to the uninitiated.

Understandably, the rules for these pension plans are not particularly susceptible to simple descriptions. In addition, there has been little new plan formation in recent years, except with respect to so-called cash-balance pension plans. The emphasis in any materials relating to these plans should be the need for expert advice to administer the plans properly.

Governmental 457(b) plans and non-governmental 457(b) plans are subject to such different rules that the two categories of plans should probably not be handled in the same plan-operation guidance. Governmental 457(b) plans are subject to a trust requirement for plan assets that is similar to the trust rules applicable to qualified retirement plans. Governmental employers generally offer participation in their 457(b) plans to a broad cross-section of employees, similar to coverage mandated for qualified plans. On the other hand, 457(b) plans maintained by tax-exempt (nongovernmental) organizations are not subject to a trust requirement. Such plans are maintained on an unfunded basis. In fact, in order to avoid a conflict between the funding/fiduciary rules of Title I of ERISA and Code section 457(b), participation in such plans is generally limited to senior management employees. Non-governmental 457(b) plan operational guidance should probably wait for awhile.

V. RECOMMENDATIONS

We also recommend that TE/GE:

(1) Continue to publish plan-operation guidance, especially checklists, for employers.

(2) Complete the comprehensive resource guides that we began in Exhibits G and H and publish them on the IRS website.

(3) Someday prepare similar guidance for plan participants.

We also recommend that TE/GE continue to ask the employee-plans members of ACT to preview plan-operational guidance under development by TE/GE, even though the ACT members will also be working on other discrete projects. This role may not result in formal recommendations, but it should nevertheless provide TE/GE with the perspective of an experienced group of practitioners.

VI. ACKNOWLEDGEMENTS

As with all ACT projects, the EP Operational Guidance project would not have been completed without the wholehearted support of the TE/GE staff. Obviously, this Report primarily involved staff of the EP Division of TE/GE. Carol Gold (Director, EP) was very supportive and gracious with her time. Paul Shultz (Director, EP Rulings and Agreements) provided valuable encouragement and suggestions.

As might be expected for a project involving TE/GE customer education materials, Mark O'Donnell (Director, EP Customer Education and Outreach) and Peter McConkey (Staff Assistant), were very involved with the entire project and participated in mutual "brainstorming" sessions. They were also incredibly proactive, asking for ACT input on various initiatives and proceeding to implement numerous suggestions and ideas, without waiting for the project to be completed.

We also spent considerable time with the 401(k) compliance group (including Mikio Thomas, Terry Holloway, Carol Schille, Lisa Mojiri-Azad, and Roger Kuehnle), working with material they had pulled together. Bob Architect (Senior Tax Law Specialist), helped us through the substantial amount of 403(b) materials already available from the IRS and helped us determine where our suggestions would be the most useful.

VII. EXHIBITS

Exhibit A – SEP Checklist

SEP CHECKLIST

This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Simplified Employee Pension (SEP). This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important tax rules. Underlined text below will link you to Internet information.

1. Are all eligible employees participating in the SEP? Yes ☐ No ☐

Any employee who is at least 21 years of age, was employed by you for 3 of the immediately preceding 5 years, and received compensation from you of at least $450 during the year (subject to cost-of-living adjustments after 2004) is eligible to participate in a SEP.

2. Is the business that the SEP covers the only business that you and/or your family members own? Yes ☐ No ☐

Employees of other businesses you and/or your family members own may have to be treated as employees when determining who is an eligible employee under this SEP.

3. Have you given all of your eligible employees information about the SEP? Yes ☐ No ☐

You must give your employees certain information about the SEP, including a copy of the SEP document. Form 5305-SEP is your SEP document if you use the model form.

4. Are you determining each eligible employee's compensation using an appropriate definition in accordance with your SEP document? Yes ☐ No ☐

Compensation used to determine contributions is limited to $200,000 for 2003, 205,000 for 2004, and is subject to cost-of-living adjustments in later years.

5. Are contributions made only to a traditional IRA? Yes ☐ No ☐

All SEP contributions must go to traditional IRAs set up for the eligible employees.

6. Are SEP contributions to each employee's IRA limited as required by law? Yes ☐ No ☐

Contributions to a SEP-IRA are limited to the lesser of 25% of the employee's compensation for the year or $40,000 for 2003 ($41,000 for 2004, and subject to cost-of-living adjustments for later years).

7. Are employer contributions immediately 100% vested? Yes ☐ No ☐

Employer contributions cannot be conditioned on anything. Once made, the employee owns all contributions.

8. Have you made required top-heavy minimum contributions to the SEP? Yes ☐ No ☐

If a SEP is top-heavy or deemed top-heavy, contributions must be made for the non-key employees equal to the lesser of 3% of compensation or a percentage equal to the highest contribution rate of any key employee.

9. Have you deposited employer contributions timely? Yes ☐ No ☐

Employers have until the due date, including extensions, of their tax return to deposit employer contributions in order to obtain a deduction.

10. If the model Form 5305-SEP was used to set up the plan, is this SEP your business's only employee retirement plan? Yes ☐ No ☐

A sponsor of a SEP established using model Form 5305-SEP cannot sponsor another retirement plan, such as a 401(k) plan.

If you answered "No" to any of the above questions, you may have a mistake in the operation of your SEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877) 829-5500**

IRS Department of the Treasury Internal Revenue Service Publication 4285 (5-2004) Catalog Number 37997E
www.irs.gov

Exhibit B – SARSEP Checklist

SARSEP CHECKLIST

This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

For Business Owner's Use

(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Salary Reduction Simplified Employee Pension (SARSEP). This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important tax rules. Underlined text below will link you to Internet information.

1. Was your SARSEP established prior to January 1, 1997, and subsequently amended for current law? Yes ☐ No ☐

No new SARSEPs can be established after 1996. SARSEPs should be updated to benefit from the new law.

2. Do you have 25 or fewer eligible employees? Yes ☐ No ☐

Only businesses with 25 or fewer eligible employees can contribute to a SARSEP.

3. Are all employees who are at least age 21, worked for you in at least 3 of the last 5 years and have received at least $450 during the year in compensation included in the plan? Yes ☐ No ☐

Employees of other businesses you and/or your family members own may have to be treated as employees when determining who is an eligible employee under the SARSEP.

4. Are you determining each eligible employee's compensation using an appropriate definition in accordance with your 5305A-SEP document? Yes ☐ No ☐

Compensation used to determine contributions is limited to $200,000 for 2003, $205,000 for 2004, and is subject to cost-of-living adjustments in later years.

5. Are all employee elective deferrals within the appropriate limit: $12,000 for 2003, $13,000 for 2004, $14,000 for 2005? Yes ☐ No ☐

For employees age 50 or over, additional catch-up contributions of up to $2,000 can be made for 2003, $3,000 for 2004, and $4,000 for 2005.

6. Do 50% or more of all eligible employees make employee elective deferrals? Yes ☐ No ☐

At least half of your eligible employees must make employee elective deferrals to the SARSEP.

7. Are total contributions (employee elective deferrals and nonelective employer contributions) no more than 25% of compensation? Yes ☐ No ☐

For 2002 and 2003, contributions are limited to the lesser of 25% of compensation or $40,000. The dollar amount is adjusted annually for changes in the cost of living. The amount is $41,000 for 2004. SARSEPs do not permit employers to make matching contributions to participants' accounts.

8. Did you deposit employee elective deferrals timely? Yes ☐ No ☐

Employee elective deferrals must be remitted to the appropriate financial institution as soon as possible but, in any event, no later than 15 days following the month in which the employee would have otherwise received the money.

9. Did you perform the annual average deferral percentage test? Yes ☐ No ☐

The amount deferred each year by each highly compensated employee as a percentage of pay (the deferral percentage) cannot exceed 125% of the average deferral percentage of all eligible nonhighly compensated employees.

10. Have you made required top-heavy minimum contributions to the SARSEP? Yes ☐ No ☐

Refer to your plan document for information. Most plans are deemed top-heavy, but some plans require annual testing.

If you answered "No" to any of the above questions, you may have a mistake in the operation of your SARSEP. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877) 829-5500**

IRS Department of the Treasury Internal Revenue Service Publication 4286 (5-2004) Catalog Number 37998P www.irs.gov

Exhibit C – Simple IRA Plan Checklist

SIMPLE IRA PLAN CHECKLIST

This Checklist is *not* a complete description of all plan requirements, and should *not* be used as a substitute for a complete plan review.

For Business Owner's Use
(DO NOT SEND THIS WORKSHEET TO THE IRS)

Every year it is important that you review the requirements for operating your Savings Incentive Match Plan for Employees of Small Employers (SIMPLE) IRA plan. This Checklist is a "quick tool" to help you keep your plan in compliance with many of the important tax rules. Underlined text below will link you to Internet information.

1. Does your business have 100 or fewer employees? Yes ☐ No ☐

Businesses with more than 100 employees (including full-time, part-time, and seasonal employees) with individual earnings of at least $5,000 yearly cannot establish a SIMPLE IRA plan.

2. Is this SIMPLE IRA plan your business's only retirement plan? Yes ☐ No ☐

A business with a SIMPLE IRA plan generally cannot also sponsor any other retirement plan, such as a 401(k) plan.

3. Do you know how to, and did you, identify your eligible employees? Yes ☐ No ☐

An eligible employee is one with compensation of at least $5,000 per year in any 2 prior years, who is expected to earn at least $5,000 this year.

4. Is the business that the SIMPLE IRA plan covers the only business that you and/or your family members own? Yes ☐ No ☐

Employees of other businesses you and/or your family members own may have to be considered when determining who is an eligible employee under this SIMPLE IRA plan.

5. Did you notify your eligible employees of their right to elect salary reduction or modify a prior salary reduction agreement? Yes ☐ No ☐

Each year, you must give your employees notice before November 2 of their right to participate in the retirement plan for the next year and to change a prior salary reduction agreement.

6. Do you give your employees an annual notice, before November 2 of each year, of plan provisions and employer contribution levels for the upcoming year? Yes ☐ No ☐

You must give your employees notice of the plan provisions and employer contribution levels, including any plan changes, at least 60 days prior to the start of the next calendar year.

7. Have you allowed employees to terminate their salary reduction election? Yes ☐ No ☐

You must allow your employees, *at any time,* to stop making deferrals.

8. Have you deposited employee deferrals timely? Yes ☐ No ☐

You must deposit an employee's deferral in the IRA as soon as possible, but no later than 30 days following the month in which the employee would have otherwise received the money.

9. Have you deposited employer contributions timely? Yes ☐ No ☐

As an employer, you have until the due date, including extensions, of your tax return to deposit matching contributions or nonelective contributions.

10. Are employee deferrals to SIMPLE IRAs limited as required by law? Yes ☐ No ☐

The deferral limit to a SIMPLE IRA is $8,000 for 2003, $9,000 for 2004, and $10,000 for 2005. Catch-up contributions of participants, aged 50 or over, are limited to an additional $1,000 for 2003, $1,500 for 2004, and $2,000 for 2005.

If you answered "No" to any of the above questions, you may have a mistake in the operation of your SIMPLE IRA plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS.

- **contact your benefits professional**
- **visit the IRS at www.irs.gov/ep**
- **call the IRS at (877) 829-5500**

IRS Department of the Treasury Internal Revenue Service Publication 4284 (5-2004) Catalog Number 37994X
www.irs.gov

Exhibit D 401(k) Plan Checklist (Long Form)

Annual 401(k) Plan Check-List

Plan Document and SPD

Have you updated your plan document for any changes made this year? *(If you have made any changes, be sure that all your advisors are aware of the changes.)*	☐ Yes ☐ No ☐ NA
If you have amended your plan, have you also amended your summary plan description (SPD)? *(The SPD must be given to each employee within 90 days after the he or she becomes a plan participant. Whenever the plan is amended, the SPD must be amended.)*	☐ Yes ☐ No
If you have made changes to your SPD, have you properly informed your employees of the changes? *(If an SPD is materially modified, a summary of the material modification [SMM] must be given to plan participants within 210 days after the end of the plan year in which the modification was adopted.)*	☐ Yes ☐ No
Have the trustees of your plan changed? *(If so, you need to inform your TPA of the change and update your plan document and SPD.)*	☐ Yes ☐ No

Eligibility and Participation

Have you provided your TPA with a list of **all** employees employed during the year, along with dates of birth, dates of hire, dates of termination, number of hours worked and compensation for the plan year? *(Employers sometimes incorrectly assume that certain employees, such as part-timers, are not covered by the plan. If the TPA is provided with information regarding all employees who receive a Form W-2, the TPA can help ensure that no eligible employees are omitted.)*	☐ Yes ☐ No
Did new employees enter the plan on the proper entry date? *(Employers sometimes forget to enroll employees when required, necessitating corrective contributions.)*	☐ Yes ☐ No ☐ NA

Have you established, acquired, or sold any businesses this year and informed your TPA? *(Business ownership changes can create issues regarding participant eligibility, coverage, and nondiscrimination.)* ☐ Yes ☐ No

Have you established any new qualified plans this year and informed your TPA? *(Each TPA of each plan should be informed about all plans.)* ☐ Yes ☐ No

Contributions

Have you deposited employee deferrals each pay period? *(You are required to deposit employee deferrals into the plan as soon as reasonably possible. Most employers make employee-deferral deposits when making payroll-tax deposits.)* ☐ Yes ☐ No

Have you informed your employees age 50 and over of their right to make catch-up deferrals? *(If your plan gives over-age-50 employees the right to make "catch-up" deferrals, you must inform employees of that right.)* ☐ Yes ☐ No

Nondiscrimination Testing

Have you identified for your TPA all corporate officers and shareholders? *(To properly test your plan for nondiscrimination, your TPA must know which participants are officers or shareholders.)* ☐ Yes ☐ No

If any employees are related (husband/wife; parent/child, etc.), have you provided that information to your TPA? *(Nondiscrimination tests sometimes treat employed family members as if they were one employee.)* ☐ Yes ☐ No

In reporting employee compensation to your TPA, have you used the plan's definition of compensation? *(Your plan uses a specific definition of compensation for benefit calculations and nondiscrimination testing. Problems can arises if you don't use the plan's definition.)* ☐ Yes ☐ No

Employee Communications

Has the summary annual report (SAR) been distributed to plan participants? *(Each participant is entitled to receive an SAR regarding plan financial matters. The Form 5500 can be provided as an alternative to an SAR.)*

☐ Yes ☐ No

Governmental Reporting

Have you filed a Form 5500 this year? *(A Form 5500 annual report must generally be filed within seven months after the plan year end.)*

☐ Yes ☐ No

Was your plan audited by an independent accountant? *(Most plans with more than 100 participants are required to be audited and have a copy of the audit report attached to the Form 5500. See instructions to the Form 5500.)*

☐ Yes ☐ No

Bonding and Fiduciary Insurance

Do you have adequate fidelity bonding? *(You are required to maintain a fidelity bond protecting the plan against loss from fraud or dishonesty. The bond amount must be at least 10% of plan assets, except that the minimum must be $1,000 and the maximum need not exceed $500,000.)*

☐ Yes ☐ No

Do you have adequate fiduciary insurance? *(Fiduciary insurance is not required. Nevertheless, many employers provide such coverage for the employees who act as employee-benefit-plan fiduciaries.)*

☐ Yes ☐ No

☐ NA

Exhibit E – 401(k) Plan Checklist (Short Form)

Annual 401(k) Check-up

Is Your Plan Being Operated Properly?

	YES	NO
PLAN DOCUMENT		
1) Were any changes made in the operation of the plan also reflected by an amendment to the plan document and the Summary Plan Description (SPD)?	☐	☐
2) If any changes were made to the plan document, have you coordinated these changes with your advisors, third party administrator (TPA) and personnel with responsibility for the operation of the plan?	☐	☐
ELIGIBILITY & PARTICIPATION		
3) Were all eligible employees identified and given the opportunity to make a salary deferral election? *(Employers sometimes forget to enroll employees when required, necessitating corrective contributions from the employer.)*	☐	☐
4) Have you provided your advisors and/or TPA with a list of all employees employed during the year, along with hire dates, birth dates, termination dates, number of hours worked, and compensation for the year? *Employers sometimes incorrectly assume certain employees, such as part-timers, are not covered by the plan. By providing the TPA or advisor with information regarding all employees who receive a W-2, you can ensure no eligible employees are omitted.)*	☐	☐
CONTRIBUTIONS		
5) Have you timely deposited employee deferrals each pay period? *(You are required to deposit employee deferrals into the plan as soon as reasonable possible. Most employers deposit employee deferrals when making payroll tax deposits)*	☐	☐
6) If your plan document allows for catch-up contributions, did you inform each of your employees age 50 and over of their right to make catch-up deferrals?	☐	☐
NONDISCRIMINATION TESTING		
7) Have you identified for your advisor or TPA, all the employees eligible to make a deferral at any time during the plan year, along with any corporate	☐	☐

	YES	NO
officers and shareholders? *(Proper testing of your plan starts with knowing which employees to include on your nondiscrimination test.)*	☐	☐
8) Was the plan's definition of compensation used to determine the compensation amounts included on the nondiscrimination tests? *(Your plan uses a specific definition of compensation for plan allocations and nondiscrimination testing)*	☐	☐
9) Did you know if your plan was a 'Safe Harbor 401(k)' you may limit the number of nondiscrimination tests required, allowing your highly compensated employees to defer up to the maximum IRC 402(g) limit, $13,000 for 2004? *(A safe harbor 401(k) plan requires an employer contribution of either 3% of eligible compensation , or a matching contribution of 100% of the first three percent of deferrals, plus 50% of the next two percent.)*	☐	☐
EMPLOYEE COMMUNICATION		
10) Has the Summary Annual Report (SAR) been distributed to plan participants? *(Each participant is entitled to receive a SAR regarding plan financial matters)*	☐	☐
11) Have you filed a Form 5500 return this year? *(A Form 5500 series return must generally be filed within seven months after the plan year end.)*	☐	☐
12) Do you have adequate fidelity bonding? *(You are required to maintain a fidelity bond protecting the plan from fraud and dishonesty.)*	☐	☐

If you answered "No" to any of the above questions, you may have made a mistake in operating your IRC 403(b) plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS. We suggest that you contact your benefits professional. For more information, visit the IRS Retirement Plans web page at www.irs.gov/ep or call IRS TE/GE Customer Account Services toll-free at 1-877-829-5500.

Exhibit F "Who Does What" Checklist

Who Does What

Making Sure Your 401(k) is Well Cared-For

Who is making the federal income tax withholding deposits and preparing Form 1099-R and Form 945?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who distributes the beneficiary designation forms to employees?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who retains the beneficiary designation forms signed by employees?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who determines which employees are eligible to participate?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for making sure that the annual employer contribution is properly allocated to participant accounts according to the plan document?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Who is responsible for determining the vested benefits of each participant?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for determining forfeitures and allocating them?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for reviewing qualified domestic relations orders?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for processing qualified domestic relations orders that have been approved?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who prepares the Form 5500 for the plan?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for providing participants with information regarding benefit options, such as the joint and survivor annuity option?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Who is responsible for preparing the summary annual report?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for distributing the summary annual report to participants?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for preparing individual benefit statements for participants?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for preparing illustrations of alternative distribution options?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for providing the distribution election forms to a participant who desires a distribution?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for making investment decisions?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for implementing investment decisions?

- ☐ Employer
- ☐ TPA
- ☐ Other (who?) _____

_____

Who is responsible for allocating earnings and losses among participant accounts?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for making sure the plan stays current with changes in pension law?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Exhibit G – 401(k) Plan Resource Guide

401(k) PLAN RESOURCE GUIDE

If you are an employer that has established a 401(k) plan, this guide is for you. You've chosen a 401(k) plan provider and, with the provider's assistance, designed the plan as desired. You are ready to start (or continue) plan operations and contributions.

First, congratulations on offering this important employee benefit. A 401(k) plan can create significant retirement security for you and your employees. For a list of advantages that a 401(k) plan can offer to employers and employees, see "Lots of Benefits."

Second, we would like to provide this guide as a resource for you as you operate your plan in compliance with the law. We have tried to make this a very practical guide that describes some of the fundamental questions you may have in operating your plan. We have also included discussions of common problems and issues that employers experience. We hope this guide helps you to operate this important employee benefit. Please let us know any suggestions you have for ways to improve this guide or additional items that would help you with your 401(k) plan.

For information about choosing a retirement plan, such as whether a section 401(k) plan is best for you, see "Choosing a Retirement Solution for Your Small Business" *[Insert hyperlink]*. For information about choosing a retirement plan provider, go to www.selectaretirementplan.com, an interactive website sponsored by the Department of Labor, the U.S. Chamber of Commerce, and the Small Business Administration. For general information about establishing a section 401(k) plan see the Internal Revenue Service publication "401(k) Plans for Small Business" *[Insert hyperlink]*.

The Plan Documents

The law requires that you administer your plan in accordance with the governing document, which is called the "plan document." Your plan document may consistent of a separate adoption agreement and an underlying or "basic" plan document and a separate trust, or it might be a single document.

The law also requires you to provide your employees with a document that explains the terms of the plan in easy-to-understand language. This document is called the "summary plan description" or "SPD." Beware of reading the SPD in lieu of reading the plan document. The SPD is not intended to contain all the details of the plan.

You may have other documents associated with your retirement plan, such as record keeper agreements, investment adviser agreements, salary deferral forms, and other administrative documents.

You should become familiar with your plan document, and especially with the provisions that relate to the topics described in this guide.

Who Is Responsible for Your Plan?

Ultimately, you are responsible for the proper administration of your plan. However, like most employers, you may have hired one or more service providers to assist you. A typical service provider might be a record keeper, accountant, bank, or investment firm. In this guide, we will refer to your primary service provider as your "third-party administrator" or "TPA."

We have prepared a "Who Does What Checklist" to help plan sponsors like you identify the role of your various service providers. *[Insert hyperlink.]*

Who is Eligible to Participate (Eligibility and Participation)?

A very common mistake employers make in maintaining 401(k) plans is excluding employees who should be included in the plan. To avoid this mistake, start by considering all of your employees (everyone who receives a W-2).

> For guidance on whether you should classify a worker as an employee or an independent contractor go to www.irs.gov/publications/p15a/index.html or see www.irs.gov/businesses/small/article/0,,id=99921,00.html.

We recommend that you prepare your census to include all employees, not just eligible participants. Make sure that the census data is reconciled with your annual payroll data to avoid any inadvertent errors! In our experience, we found this area to be the one that creates the most errors.

Your employee census should list every employee who received wages during the year. You should also include in your census, each employee's date of birth, date of hire, date of termination of employment (if applicable), hours worked, and wages for the year.

Another common mistake is failing to include employees of related employers. Sometimes separate employers must be treated as one. This is true, for example, when different employers or under common control or are affiliated in certain ways. *[If possible, insert a hyperlink to relevant material.]*

Eligibility Requirements. Your plan may have eligibility requirements, such as a requirement that an employee be a minimum age or complete a specified amount of service before becoming a participant. Be sure to be familiar with any age and service requirements in your plan.

If your plan has eligibility requirements, it is probably necessary to track hours and years of service. This is because the law has very specific rules on how you count service for retirement plan purposes. These rules will be found in your plan document as well.

Typically, a "year of service" for retirement plan purposes is 1,000 hours of work. An employee who works 20 hours per week will work 1,000 hours or more during the year. So you can see that some part-time employees may become eligible to participate in your plan.

Rehired Employees. Special rules apply if you rehire a former employee. Generally, you must count all of an employee's service with you in determining eligibility to participate. Additionally, a former employee who was a plan participant usually becomes a plan participant immediately upon being rehired. Be sure to advise your plan administrator whenever you rehire a former employee.

Entry Dates. "Entry Dates" are the dates on which an eligible employee becomes a participant. The law requires that an employee become a participant within six months after meeting the eligibility requirements. Because of this rule, many plans have at least two entry dates: the first day of the year and the first day of the seventh month of the year. Other plans have one entry date each month. Be sure to be familiar with your plan's entry dates. Entry dates will be included in your plan document.

Entry dates are very important! If you fail to make an eligible employee a participant on the proper entry date, you violate the law. You will be required to make up contributions for the employee whose participation was improperly delayed.

Employees on Leave.

Collectively-Bargained Employees. If you have employees who are members of a union, they might be excluded from your 401(k) plan. It depends upon the provisions in your plan document. If you want to exclude union employees from your plan, be sure to inform the person who drafts your plan.

How Can Money go into the Plan (Contributions)

Employer Contributions. Usually, an employer is not required to contribute to a 401(k) plan. However, some employers include provisions in their plans that require a contribution, such as a required matching contribution. Matching contributions need not be part of your 401(k) plan. If you include a matching contribution provision, the matching contributions may be required or may be discretionary.

In addition to matching contributions, the plan usually permits employers to make a discretionary contribution. The maximum deductible contribution by an employer is 25% of the wages of all plan participants.

Employee Contributions. As you already know, the main purpose of a 401(k) plan is to permit employees to defer part of their wages and have the deferred amount contributed to the plan on their behalf. The employee's deferral is referred to as an "elective deferral." Tax law imposes a limit on an employee's elective deferrals each calendar year. The maximum permitted elective deferral is an amount equal to the lesser of 100% of the employee's wages or (in 2004) $13,000. (The dollar limitation changes from time to time.)

Many 401(k) plans impose a lower limit on elective deferrals than the limit described above. If your plan imposes a lower limit, the lower limit controls.

Catch-up Contributions.

The Rollover Contributions. Your plan may permit an employee to roll money into your plan from other plans. If your plan permits rollovers, you must notify new employees of this right.

Timing of Contributions. As the sponsor of a 401(k) plan, you need to be aware of the rules that apply to the timing of contributions. First, with respect to any employer contributions, such as a matching contribution or discretionary contribution, the contribution must be made on or before the date on which you file your business tax return. If you extend your return, you will have a longer time to make an employer contribution. Contributions made before you file your tax return are treated as if they were made on the last day of the plan year.

Special rules apply to employees' elective deferrals. Since the amounts withheld from wages are the employees' money, you are required to deposit this money into the plan as soon as reasonably possible. It is a good practice to make a contribution of elective deferrals at the same time you deposit your payroll taxes each pay period.

Top Heavy Minimum Contributions (If Plan is "Top Heavy"). A plan is considered "top-heavy" if 60% or more of the money in the plan is for the benefit of "key employees." The definition of "key employees" includes certain officers and shareholders of your company. It *may* also include certain family members. Your plan administrator should determine whether your plan is top-heavy.

If your plan is top-heavy, you ***may be required*** to make a minimum contribution for your participants. Consult with your professional advisors regarding any minimum contribution requirements.

General Limits on Contribution Amounts

[Explain how the limits apply to multiple plans. It is important to explain to the employer that this issue must be referred to the TPA.]

Determining Compensation *[401(a)(17)]*

Special Limits on Contributions by/for Highly Compensated Employees (Nondiscrimination Testing)

"Safe Harbor" 401(k) Plans

Who Makes Plans Investment Decisions

Employer-Directed Accounts

Employee-Directed Accounts

ERISA Section 404(c)

DOL and Fiduciary Requirements

Prohibited Transactions

When and How Is an Employee Entitled to Money from the Plan (Vesting)?

Plan Loans

Hardship Distributions

Minimum Required Distributions

Automatic Cash-outs of Small Accounts

Distribution Forms and Distribution Options

Joint and Survivor Requirements

Rollovers

Splitting Accounts Upon Divorce (Qualified Domestic Relations Orders)

Federal Income Tax Withholding

Form 1099R

Reporting Distributions

When Amounts are Forfeited From Plan Accounts (Vesting)

General Vesting Rules

Top Heavy Vesting

Forfeitures

What Documents Must Be Provided to Participants

Salary Reduction Forms

Beneficiary Designation Forms

Summary Plan Description and Material Modifications

Summary Annual Reports

Individual Benefit Statements

Potential Penalties for Failing to Provide Requested Information

What Government Reporting is Required?

Form 5500 *[Link to Form 5500 Instructions.]*

Are Independent Audits Required?

Bonding Requirements and Fiduciary Insurance

Will the IRS approve your 401(k) Plan

Pre-approved plans

Plans submitted for approval

What Happens if I make a Mistake (Correction Issues)?

Correcting Operational Errors

"Lost" Participants

Exhibit H

GOVERNMENTAL EMPLOYERS' 403(b) PROGRAM
RESOURCE GUIDE

If you are an employer that has established a Section 403(b) program, or are responsible for administering a 403(b) program, this guide is for you. You have chosen one or more 403(b) program vendors and, with their assistance, designed the plan as desired. You are ready to continue (or start) plan operations and contributions.

We are providing this guide as a resource for you as you operate your plan in compliance with the law. We have tried to make this a very practical guide that describes the fundamental questions you may have in operating the plan. We have also included discussions of common problems and issues that employers experience. We hope this guide helps you to administer this important employee benefit. Please let us know any suggestions you have for ways to improve this guide or additional items that would help you with your 403(b) program.

Additional Resources

Additional information that may be helpful to you may be found in:

- For common questions employers and employees have, see "Frequently Asked Questions regarding Tax-Sheltered Annuities" *[insert hyperlink]*;
- For information on recent law changes, see "Partnership for Compliance – Tax Sheltered Annuities," IRC 403(b) Outreach Program *[insert hyperlink]*;
- For information on correcting mistakes, see "403(b) Plan Checklist" and Employee Plans Compliance Resolution System *[insert hyperlink]*;
- IRS Publication 571, Tax Sheltered Annuity Plans for Employees of Public Schools and Certain Tax-Exempt Organizations, *[insert hyperlink]*;
- IRS Examination Guidelines on 403(b) Programs *[insert hyperlink]*
- **[NOTE: Eventually will insert the final regulations link here also.]**

The Program Documents

A 403(b) program may have several governing documents. Depending on the type of program you have, you may have a "plan" document outlining the primary program terms, a group annuity contract, a trust agreement and/or a program description. Different 403(b) programs and vendors use different documents. Only in an employee salary reduction only program might there be only individual annuity contracts, where there are no group documents available. One of the first things you should do when you begin administering the program is to make sure you have all up-to-date, fully signed documents for your 403(b) program. Check with your vendor or vendors, and the prior administrator for the documents. These contain what should be your primary reference point when you or other employees have questions about the program.

You may have other documents associated with your program, such as recordkeeper agreements, investment adviser agreements, salary deferral forms, and other administrative documents.

Who Is Responsible for the Program?

Ultimately, in many cases, the employer is responsible for the proper administration of the 403(b) program. The employer is responsible for withholding the proper amount for employees' salaries for federal tax. If an employees exceeds the amount of contribution that can be properly deferred into the plan, the excess is taxable income to the employee. The employer could be subject to penalties for federal income tax withholding and FICA (if applicable) taxes that should have been withheld on the excess contribution. However, like many employers, you may have hired one or more service providers to assist you or to actually be responsible for the program. A typical service provider might be a recordkeeper, accountant, bank, or investment firm. In this guide, we will refer to your primary service provider as your "third-party administrator" or "TPA."

Many governmental employers feel they are "insulated" from any responsibility due to "hold harmless" agreements with the vendors. While that can provide some protection and recovery, remember that the "hold harmless" agreement is between the school system and its vendors. If the 403(b) program has failures that result in additional federal withholding or FICA tax, the employer will be responsible for the proper amount of tax due. If those amounts can be recovered under a hold harmless agreement that is fine, but that could be long after the IRS payments are due.

Who is Eligible to Participate

A very common mistake employers make in maintaining 403(b) programs is excluding employees who should be included or at least offered the choice of contributing or not to the program. To avoid this mistake, start by considering all of your employees (everyone who receives a W-2). *[Cross-link to publications regarding who should get a W-2.]* We recommend that you prepare your census to include all employees, not just eligible participants. Make sure that the census data is reconciled with your annual payroll data to avoid any inadvertent errors! In our experience, we found this area to be the one that creates the most errors. Special care should be taken to comply with this requirement. Non-compliance could result in the entire 403(b) program losing its tax-favored treatment.

Once an employer permits any employee to elect a salary deferral into a 403(b) program, the opportunity must be extended to all employees of the organization who may elect to make contributions of more than $200 pursuant to a salary reduction agreement. There may not be age and service requirements imposed on this ability. In addition, meaningful notice of this right should be given to all employees. Consider giving a notice as part of their initial employment package. Also, consider additional periodic notices of this right, for example, at the beginning of each school year.

There are certain employees who may be excluded. Employees who may be excluded include:

- employees who are participants in an eligible deferred compensation plan (457 or 401(k)) or participants in another 403(b) program,
- non-resident aliens,
- certain students, and
- employees who normally work less than 20 hours per week.

If you have employer contributions to the 403(b) program, your program may have eligibility requirements for these contributions (e.g., age, service, employee classification). Those requirements will make it necessary for the school to track when an employee becomes eligible for the employer contributions.

Where to go for Additional Information and Assistance

The IRS has several ways to assist you in administering a 403(b) program

- For specific questions, the IRS EP Call Site is available at _____
- The IRS currently has a program called the Section 403(b) Tax Sheltered Annuity Partnership for Compliance. Under the Partnership for Compliance, trained and experienced IRS employees will be made available to provide educational services relating to section 403(b) tax sheltered annuity arrangements including delivering speeches, participating in panel discussions, conducting training sessions and helping prepare newsletter articles. Through these services, the IRS can provide information about the unique aspects of tax law applicable to tax sheltered annuities and the problems that arise with them. For example, information can be provided on the impact to both the employer and employee if excess contributions have been made, improper compensation had been included for calculating excludible amounts, or early distributions have been made to employees. Organizations interested in section 403(b) tax sheltered annuities may request educational services under the Partnership for Compliance.

Additional Issues that the IRS may wish to cover in subsequent editions of the Governmental Employer Resource Guide

In this section, we note areas that we think the IRS may decide it would be helpful to add in the future. Depending on customer usage and comments, this Guide could serve as an entry point to all pertinent IRS materials.

- **How Can Money go into the Plan (Contributions)**
  - **Employer Contributions**
  - **Employee Contributions**
  - **Timing of Contributions**

- **Limits on Contributions**

  [Include explanation of how the limits apply to multiple plans. It is important to explain to the employer that this issue must be referred to the TPA.]

  - **Determining Compensation *[401(a)(17)]***

- **Catch-up Contributions**

- **When Is an Employee Entitled to Money from the Plan (Vesting)?**

  - **General Vesting Rules**

  - **Forfeitures**

- **When can a Participant Take Money Out Of the Plan (Loans and Distributions)?**

  - **Plan Loan Discussion and Documents**

  - **Hardship Distributions**

  - **Minimum Required Distributions**

  - **Involuntary Cash-Outs**

  - **Federal Income Tax Withholding**

  - **Form 1099R**

- **What do Participants need to receive about the Plan**

  - **Salary Reduction Forms**

  - **Beneficiary Designation Forms**

  - **Individual Benefit Statements**

- **Who Is in Charge of Investments?**

  - **Employer-Directed Accounts**

  - **Employee-Directed Accounts**

- **What Happens if I make a Mistake (Corrections Issues)?**

  [We thought this discussion could be useful in this section.] In order to use the IRS voluntary correction program, a 403(b) program plan sponsor must have established practices and procedures in place and routinely followed to facilitate

compliance with the Internal Revenue Code, but through an oversight or a mistake in applying them or an inadequacy in the procedures, an operational failure occurred. The practices and procedures may be at the plan sponsor, vendor or third party administrator level. A determination about whether the plan sponsor has practices and procedures in place will be made based on the facts and circumstances in each case. Some examples of practices and procedures are (1) payroll procedures that identify contributions in excess of the salary deferral limit; (2) a procedure to review contribution limitations for participants; (3) a system to review part-time employees or substitute teachers to assure all eligible employees are given the opportunity to participate; and (4) a procedure to identify participants who are eligible for extra amounts in their deferral contributions. As noted above, the determination of the presence of practices and procedures is based upon the facts and circumstances in each case. The individual examples above may not necessarily result in a finding that practices and procedures exist. It should be noted that these practices and procedures must be reasonably designed to promote and facilitate overall compliance with the requirements for 403(b) programs.

- **What is a Qualified Domestic Relations Order?**

Additional Issues the IRS may wish to cover in subsequent editions of the Non-Governmental Employer Resource Guide

In this section, we note areas that we think the IRS may decide it would be helpful to add in the future.

Are there any special benefit rules (Nondiscrimination Testing)? [Non-Governmental Edition]

- **Safe Harbor Plans**
- **Distribution Forms and Distribution Options**
  - **Joint and Survivor Requirements [Non-Governmental Edition]**
- **Rollovers**
- **Summary Annual Report [Non-Governmental Edition]**
- **Summary Plan Description and Material Modifications [Non-Governmental Edition]**
- **Potential Penalties for Failing to Provide Requested Information**
- **What Government Reporting is Required? [Non-Governmental Edition]**
  - **Form 5500** *[Link to Form 5500 Instructions.]*

- **Are Independent Audits Required? [Non-Governmental Edition]**
- **What are the Bonding Requirements/Fiduciary Insurance Requirements? [Non-Governmental Edition]**
  - **Section 404(c) [Non-Governmental Edition]**
  - **DOL and Fiduciary Requirements [Non-Governmental Edition]**
  - **Prohibited Transactions [Non-Governmental Edition]**

Exhibit I – 403(b) Checklist for Elementary and Secondary Public Schools

GENERAL CHECKLIST FOR 403(b) PROGRAMS OF

ELEMENTARY AND SECONDARY PUBLIC SCHOOLS

	YES	NO
1) Does your organization qualify as a K-12 public school? (These are as described in IRC 170(b)(1)(A)(ii).) (If your organization is not a public school, but an eligible tax-exempt organization, see the Checklist for 403(b) Plans of Eligible Tax-Exempt Organizations.)	☐	☐
2) Are all employees who work more than 20 hours per week given the opportunity to make a salary deferral?	☐	☐
3) Are salary deferrals limited in a calendar year to the amounts under federal law? *(Salary deferrals are limited to $13,000 for 2004, $14,000 for 2005.) (See IRC 402(g).)*	☐	☐
4) Are the total employer and employee contributions limited so as not to exceed federal limits? *(Total of employee and employer contributions cannot exceed the lesser of $41,000 for 2004 or 100% of includible compensation.)* (See IRC 415(c).)	☐	☐
5) If the 15 years of service catch-up contributions are being made, are the employees' 15 years of service all with the same employer? *(For the 15 year catch-up, an employee must meet the 15-year requirement at his/her current employer. In addition, a calculation must be made to determine prior usage of this catch-up.)*	☐	☐
6) Are the age 50 catch-up contributions limited to the federal maximum amounts and does the program allow for such contributions? *(Allowable amounts are $3,000 for 2004, $4,000 for 2005. (See IRC 402(g).)*	☐	☐
7) Does your 403(b) program's annuity investment contract contain nontransferability provisions?	☐	☐
8) If your program offers 5-year post separation contributions, are amounts contributed using a non-elective method? *(Amounts or contributions to the 403(b) program that an employee has an option of receiving in cash are considered elective deferrals. Post separation contributions need to be employer contributions.*	☐	☐

	YES	NO
9) Are the contributions to the 403(b) program kept separate from any cafeteria plan/125/flexible benefit contributions?	☐	☐
10) If you allow loans from the 403(b) program and you have multiple vendors, are all loans to a participant aggregated to test against the IRS limits of the lesser of $50,000 or 50% of the participant's total 403(b) value? *(If not, violations of the loan limits can occur.) (See IRC 403(b)___.)*	☐	☐

If you answered "No" to any of the above questions, you may have made a mistake in operating your IRC 403(b) plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS. We suggest that you contact your benefits professional. For more information, visit the IRS Retirement Plans web page at www.irs.gov/ep or call IRS TE/GE Customer Account Services toll-free at 1-877-829-5500.

Exhibit J – Annual Checkup for Governmental Employer 403(b) Programs

ANNUAL CHECKUP FOR 403(b) PROGRAMS FOR GOVERNMENTAL EMPLOYERS

[In this checklist, we would anticipate seeing brief explanations and comments added – we have included some examples of the types of things we would see being added.]

DOCUMENTS GOVERNING PROGRAM	
Have you updated the documents for the program for any changes made this year?	☐ Yes or ☐ No
If you have made changes to your plan, have you properly informed your employees of the changes?	☐ Yes or ☐ No
Who are the current 403(b) providers? Have the providers changed? If so, you may need to update your plan document.	☐ Yes or ☐ No
ELIGIBILITY AND PARTICIPATION	
Have you provided your 403(b) provider with a list of **all** employees employed during the year, along with dates of birth, dates of hire, dates of termination, number of hours worked and compensation for the plan year?	☐ Yes or ☐ No
Did new employees enter the plan on the proper entry date?	☐ Yes or ☐ No
Have you adopted any new retirement plans this year?	☐ Yes or ☐ No
CONTRIBUTIONS	
Have you deposited employee deferrals each pay period?	☐ Yes or ☐ No
Have you informed your employees age 50 and over of their right to make catch-up contributions?	☐ Yes or ☐ No

Exhibit K – Governmental Employers 403(b) Program "Who Does What" Checklist

GOVERNMENTAL EMPLOYERS 403(b) PROGRAM
"WHO DOES WHAT" CHECKLIST

This checklist is intended to help employers and vendors identify between themselves who is to handle aspects of program administration

Who is making the federal income tax withholding deposits? Who is preparing the Form 1099R and Form 945?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who distributes the beneficiary designation forms?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who retains the beneficiary designation forms?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who determines which employees are eligible to participate?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for making sure that the annual employer contribution is allocated correctly?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
If your plan provides for hardship distributions, who determines whether a participant is eligible for a hardship distribution?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Who is responsible for determining the vested benefits of each participant?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for determining forfeitures and allocating them?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for reviewing qualified domestic relations orders?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for processing qualified domestic relations orders that have been approved?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for providing the distribution election forms to a participant who desires a distribution?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for making investment decisions?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for implementing investment decisions?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Who is responsible for allocating earnings and losses among participants' accounts?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for notifying you if an amendment is required?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for informing you about changes in pension law?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Exhibit L – Non-Governmental Employers 403(b) Program "Who Does What" Checklist

NON-GOVERNMENTAL EMPLOYERS 403(b) PROGRAM
"WHO DOES WHAT" CHECKLIST

This checklist is intended to help employers and vendors identify between themselves who is to handle aspects of program administration

Who prepares the Form 5500 for the plan?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for providing participants with information regarding benefit options such as the joint and survivor annuity option?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for preparing the summary annual report?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for distributing the summary annual report to participants?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for preparing individual benefit statements for participants?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____
Who is responsible for preparing illustrations of alternative distribution options?	☐ Employer ☐ TPA ☐ Other (who?) _____ _____

Exhibit M – 457(b) Checklist for Plans of Governmental Employees

CHECKLIST FOR 457(b) PLANS OF GOVERNMENTAL EMPLOYEES

	YES	NO
1) Does your organization qualify as a state or local governmental unit?	☐	☐
2) Does an eligible employee's opportunity to make a salary deferral election only apply to future compensation?	☐	☐
3) If the plan covers any independent contractors, are they required to complete or terminate any contract with the governmental unit to receive plan distributions?	☐	☐
4) Are salary deferrals limited in a calendar year to the amounts under federal law? (Salary deferrals are limited to $13,000 for 2004, $14,000 for 2005.) (See IRC 457(b).)	☐	☐
5) Does your plan allow participants to make "catch-up" contributions during the 3 years prior to his or her year of normal retirement age? (This option is available to participants who had not made the maximum deferral contribution in earlier years.)	☐	☐
6) If the plan allows "catch-up" contributions by participants who are age 50 or older, are such contributions limited to the federal maximum amounts? (Allowable amounts are $3,000 for 2004, $4,000 for 2005.)	☐	☐
7) Has your governmental unit established a trust or comparable custodial account or annuity contract to hold the assets of the plan for the exclusive benefit of plan participants?	☐	☐
8) Are employee deferral contributions transferred to the trust, custodial account, or annuity contract within a reasonable period of time?	☐	☐
9) If your plan allows the distribution of smaller accounts (under $5,000 in 2004) prior to termination of employment, is the option restricted to employees who have not participated in the plan during the last two years?	☐	☐

YES	NO
☐	☐
☐	☐
☐	☐

10) If you allow loans from the 457(b) program, are all loans to a participant aggregated to test against the IRC limits of the lesser of $50,000 or ____% of the participant's total 457(b) value? (If not, a participant may be immediately taxable.)

11) If your program allows a distribution when a participant is faced with an unforeseeable-emergency, is such a distribution limited to situations where the emergency may not be relieved by other resources available to the participant?

If you answered "No" to any of the above questions, you may have made a mistake in operating your IRC 457(b) plan. Many mistakes can be corrected easily, without penalty and without notifying the IRS. We suggest that you contact your benefits professional. For more information, visit the IRS Retirement Plans web page at www.irs.gov/ep or call IRS TE/GE Customer Account Services toll-free at 1-877-829-5500.

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

IV. Audit Cycle Time and Communications: *Employee Plans and Tax Exempt Bonds*

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Terry Burke
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With input from the following prior year members:
Craig Hoffman
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June 9, 2004

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BACKGROUND

The ACT has previously issued reports relating to the educational and voluntary compliance aspects of TE/GE. In those reports, we identified a third, important element of the role of TE/GE: examinations or audits. Two years ago we undertook a report on TE/GE audit programs to explore methods in which the audit program can be made more effective and as painless as possible to filers. During the course of this exploration, TE/GE itself has undertaken a program related to exam reengineering (now christened the "Filing to Closure Examination Redesign Team"). This report collects ACT's observations concerning specific aspects of the audit process as it relates to Tax-Exempt Bonds and Employee Plans. A parallel report collects observations concerning the audit process as it relates to Exempt Organizations.

Purposes of an Audit

An effective audit program serves several purposes:

1. **Visible enforcement** – Encourage self-compliance by others.
2. **Correction** – Ensure that past improper practices are corrected retroactively.
3. **Compliance** – Ensure that the taxpayer operates in compliance going forward and that current rules can be complied with (demonstrate that the rules work).
4. **Data Gathering for Education** – Collect information to shape audit process and self-corrections processes.
5. **Identification of Abusive Transactions** – Identify and examine potentially abusive transactions in a timely fashion.

Self-compliance is the cornerstone of U.S. tax compliance. An effective audit program can encourage higher compliance by ensuring that non-compliers are targeted for audit and that persons who are abusing the tax process experience heavy penalties relative to those who are merely negligent or who do not profit from their non-compliance. Accordingly, we believe that audit processes should be shaped to target abusive practices and be more tolerant of those who do not profit from their noncompliance.

Auditors should determine whether required tests and activities are undertaken, and test the honesty and integrity of the information being provided to the Service. Missed processes and inaccurate information should be corrected retroactively, and the Service should be prepared to help those audited identify how to correct their processes and information going forward.

An effective audit program should include informational feedback elements to help the Service in its other missions. Results of audits should be used to help identify

issues about which taxpayers need greater education, practices that should be reviewed as part of future audits, and areas where self-corrections processes could be expanded. Audits can also be the means by which the Service gains greater understanding of how an industry operates, as with the Service's 2003 audits of single-family housing bond issues.

Who is the taxpayer?

In income tax cases, the taxpayer and auditee are the same and easily identifiable – the individual or corporation responsible for paying the income tax. In an employee plan, the plan is audited, but the true tax risk lies with the plan sponsor, who has responsibility for administering the plan and needs to take appropriate action to keep the plan qualified, even though plan disqualification triggers tax consequences for plan participants. With tax-exempt bonds, the issuer is the taxpayer responding to the audit, even though bond disqualification triggers tax consequences for the bond holder.

GENERAL OBSERVATIONS

Below are some observations concerning the TE/GE audit process generally, focusing on Audit Cycle Time and Communications with taxpayers. Following our general observations are a discussion of these and other observations as they relate to Employee Plans and Tax-Exempt Bonds.

COMMUNICATIONS WITH THE TAXPAYER

1. **Improved Web-based Tools.** *Establish web-based audit process guides and other web-based tools.*

   We strongly support and urge the use of web-based audit process guides and information, including timeline management, hyperlinks and guides specific to taxpayer rights involving bonds, employee plans and exempt organizations.

2. **Soft Contacts.** *Initiate audits through "Soft Contacts".*

   Often the first a taxpayer hears of an audit is through a letter announcing the audit. We encourage TE/GE to seek alternate means to initiate contact. For example, the EO division has undertaken to send taxpayers with certain types of errors on their returns a brief letter, noting that the return may be inaccurate on a specific issue, and then perform an audit only if the error is not corrected, or perform the audit the following year. Accordingly, we strongly recommend the

use of "soft contact" letters where appropriate, to determine whether a particular compliance problem exists.

3. **Manage Taxpayer Expectations.** *Set expectations early and simply.*

We encourage TE/GE to clearly communicate expectations to taxpayers at the onset of the audit. Taxpayers should receive a brief letter in plain English, outlining the areas being audited (if it is a focused audit), the anticipated timeline, and the demands expected to be placed on the taxpayer. For large cases this might take the form of a much more extensive meeting or series of meetings to agree on an audit schedule. Whether the case is large or small, we encourage TE/GE to contact the taxpayer personally to discuss these expectations.

4. **Cooperative Approaches.** *We encourage TE/GE seek more cooperative approaches, and in particular to adopt a practice of entering into audit contracts of the type implemented by the Service's LMSB division.*

Our vision here is that TE/GE would have an initial meeting with the taxpayer, identify topics to be audited and expected document needs, and then agree with the taxpayer on a schedule for completing the audit. While this might be most effective with large corporations, we urge TE/GE to consider developing similar approaches for medium-sized and even small cases, such as a simple phone call followed up with a brief letter confirming expected time frames for key stages of the audit process.

5. **Advance Notice of Actions**. *We encourage TE/GE to provide ample advance notice of actions, such as IDRs, on-site visits, or actions requiring taxpayer response.*

6. **Closing Processes.** *We recommend TE/GE simplify closing letters and actively communicate general findings.* In particular, we encourage TE/GE to actively communicate findings more quickly and reduce the delay between the final on-site visit or substantive communication and the final closing letter.

7. **Communicating Common Errors.** *We recommend TE/GE prepare and communicate to taxpayers "top ten" lists of common audit problems, and "red flag" facts that suggest possible underlying problems.*

We encourage TE/GE to publicize common errors and risk areas in order to increase compliance. Something like a "Top 10" list of common problems found on audit would be a good way of raising taxpayers' consciousness.

REDUCING CYCLE TIME

"Cycle time" is defined by the IRS as the period between the date of an auditable event (such as filing of an informational return) and the date an audit is completed. From the taxpayer's point of view, the "cycle time" is measured from when the notice of audit is received to when the auditor is out-the-door and the letter of no action or other decision letter is received. Long cycle times generate taxpayer dissatisfaction and impede effective audits as memories become stale or documents become difficult to retrieve.

Below are a number of suggestions for reducing the length of time in a typical audit cycle.

1. **Case Selection.** *Employ techniques that focus examination selection on the most likely problem cases.*

   The initial selection decision is an important step in audit efficiency. Careful case selection can minimize the amount of taxpayer and TE/GE time spent on audits which don't uncover any compliance failures. We support EP's recent efforts to improve, refine and expand the use of the "risk assessment" technique for audit case selection. We encourage EP to continue to refine its risk assessment approach.

2. **Pre-Contact Planning.** *Plan the audit prior to any contact with the taxpayer.*

   Before engaging with the taxpayer, TE/GE should make every effort to prepare for the audit. This could include careful review of information on the return, identifying and reviewing information available from other resources, reviewing the Internal Revenue Manual and relevant legal authority, determining audit scope, and preparing document requests where appropriate. We encourage the TE/GE require agents to prepare accurate and focused data requests, rather than request a laundry list of documents in a kind of shotgun approach.

3. **Focused Audits.** *Develop programs to expand the use of "focused" or "limited scope" audits.*

   We also believe there are potentially greater efficiencies available through the expanded use of "limited scope" or "focused" audits – audits which target a select number of issues. By identifying a limited number of audit issues during the pre-contact planning stage, TE/GE can narrow the initial inquiry, leading to faster document production and faster resolution of those issues.

4. Different audit techniques for different case types. *Continue to apply alternate audit approaches, and in particular to implement joint agreements with taxpayers in large cases.*

Different audit approaches can and should be applied under different conditions. Variables such as the taxpayer's size, history or industry may warrant a different approach. For large cases, TE/GE should implement a program of negotiating audit schedules with the taxpayer, implementing the cooperative approaches discussed above in the context of Communication with the Taxpayer.

5. Agent Selection. *Match cases to agents based on expertise, not geography, and actively manage agent inventory.*

We believe audits will be concluded faster and with greater efficiency for both TE/GE and the taxpayer if the auditor has specific experience with the type of issues under audit. We recognize that matching the agent to the case may not always be possible within a single geography, and encourage TE/GE to carefully consider the opportunities to conclude an audit more efficiently, despite the additional travel costs of bringing in an auditor from another geographic area.

We also encourage TE/GE managers to actively review and manage agent caseload. We also encourage TE/GE to keep inventory at manageable levels, to allow agents to work cases more frequently, reduce cycle time and thereby increase throughput and decrease customer dissatisfaction with long cycle times.

6. Agent Training. *Devote significant resources to training examination agents.*

We encourage TE/GE to devote significant resources to training new examiners, and to work with outside resources to develop training materials. Attorneys and accountants experienced in responding to audits may be among the best resources to help train new auditors.

7. Active Case Management. *Actively manage cases and caseloads by establishing guidelines and norms for the amount of time a case should take, monitor agents' progress frequently, and consider use of on-line tools and administrative staff to monitor time lines.*

We recognize that each case is different and may require different resource and time commitments. However, we believe that there should be enough common elements to set reasonable norms and guidelines for how long a case should take, particularly small cases or cases handled via a correspondence audit. We encourage TE/GE to establish guidelines and norms for the amount of time a case should take, and monitor agents' activities frequently and at a depth

necessary to detect timeline problems well before the case starts exceeding the norms.

8. **Coordination with Self-Correction Procedures.** *To the extent audit cycle time is improved by initiating audits early, self-correction procedures should be modified.*

   We recommend that self-correction procedures be modified to allow certain audit-identified problems to be handled without the higher fees and penalties. Typically, taxpayers may not identify a plan defect until the next annual recordkeeping cycle. If an audit commences before that cycle is complete, the taxpayer will have been denied the opportunity to rectify the problem through self-correction.

OTHER SUGGESTIONS

We have two other suggestions which don't directly affect communications and cycle time, but which we believe deserve mention.

1. **Audit practices should be consistent nationwide**. We believe consistency is an important element of fairness in any examination program. For this reason, we recommend that TE/GE continue to devote resources to publishing "Audit Guidelines" for use by agents and plan sponsors. These guidelines should be kept up-to-date, and ideally will allow taxpayers to conduct self-audits as well has help prepare for audits initiated by TE/GE.

2. **Identify means to review third-party providers.** We believe that on occasion the practices of third parties should be targeted in audit and compliance reviews, and remedies sought against those third parties. This is an aspirational objective, and one that may require legislation or expanding the scope of Circular 230. Many taxpayers rely on vendors to manage significant parts of their programs. For example, in the issuance of tax-exempt bonds, the content experts are the underwriters and the bond lawyers, and not necessarily the bond issuers. A small governmental entity may issue only one bond series in a decade. Similarly, smaller companies rely heavily on third party recordkeepers or recordkeeper-trustees to establish and operate their retirement plans. These smaller, less sophisticated taxpayers have only superficial understanding of the requirements to which they are subject.

We encourage TE/GE to train agents in use of enforcement tools such as Section 6700 (promoter penalties) or Section 6701 (aiding and abetting penalties), referrals to the IRS Office of Professional Responsibility, or referrals to Criminal Investigation (CI). We believe TE/GE should consider using these tools more broadly, looking at systemic errors and patterns of poor compliance, and consider expanding the scope of Circular 230

EMPLOYEE PLANS

The Office of Employee Plans ("EP") within the Tax Exempt/Governmental Entities Division of the IRS ("TE/GE") has responsibility for ensuring that retirement plan sponsors understand and comply with the qualification requirements of the Internal Revenue Code and Regulations. EP does so through three main program areas: Customer Education and Outreach; Rulings and Agreements; and Examinations.

EP Examinations

The EP office of TE/GE has had an active examination program for many years. At the present time, approximately 550 revenue agents are assigned to Examinations. They are divided among six regions within the country. The National Director for EP Examinations is located in Baltimore, Maryland.

Examinations has served the traditional role of auditing employee retirement plans and their sponsors for compliance with the Internal Revenue Code. The goal of the Examinations is the promotion of compliance by identifying areas of noncompliance and developing strategies for correction. Examinations works with the other EP program areas in developing and implementing appropriate compliance and enforcement programs.

Traditionally, Examinations has shared its agent resources with Ruling and Agreements. In particular, at times of high volume of determination letter requests, many revenue agents who would normally be conducting audits of retirement plans are instead assigned to process determination letter applications. TE/GE recently introduced a new determination letter process which will spread the determination letter workload more evenly over a five-year cycle. This will allow a more consistent staffing level within the Examinations group.

Ideally, EP Examinations generally expects to conduct 8,000-12,000 audits per year. In the past, the number of audits conducted in a year has fluctuated greatly. This was principally related to the volume of determination letter applications received because of the need to reassign examination agents. The expectation is that the realignment implemented in Fall 2003 will allow for a more focused audit staff, better and more professional customer service, and an increase in the number of examinations. Revenue agents assigned to examination are expected to be more efficient and better at their jobs because of increased specialty training and continuity of job duties. The fluctuation in the number of audits conducted from year-to-year should be eliminated since resources will no longer be shared with Rulings and Agreements.

Our project group had the opportunity to talk with members of the EP management staff, both inside and outside of the Examinations program. We were

impressed by the clear desire of all to continue to improve the EP examination process. Several of the recommendations we make are intended to support ongoing initiatives already underway.

IMPROVING COMMUNICATION WITH THE TAXPAYER

We believe the taxpayer experience and taxpayer relations can be significantly improved through better communications. TE/GE has made great strides in this area as the early implementer of the Service's practice of treating taxpayers more like customers than criminals. We support many of the current initiatives and recommend other initiatives, all as discussed below:

1. **Improved Web-based Tools.** *Establish a web-based audit process guide and other web-based tools.*

   We strongly support and urge completion and implementation of a web-based audit process guide. As we understand it, this guide will be for use by plan sponsors and practitioners to provide a "road map" as to what to expect from the audit. We think that a product such as this, with hyperlinks to other resources (e.g., audit guidelines, CPE materials, etc.) would be extremely valuable. We also believe an EP-focused Publication 1 "Your Rights As a Taxpayer" would also be helpful.

2. **Soft Contacts.** *Initiate audits through "Soft Contacts".*

   Often the first a taxpayer hears of an audit is through a letter announcing the audit. We encourage TE/GE to seek alternate means to initiate contact. For example, the EO division has undertaken to send taxpayers with certain types of errors on their returns a brief letter, noting that the return may be inaccurate on a specific issue, and then perform an audit only if the error is not corrected, or perform the audit the following year. Similarly, the EP compliance unit is in the early stages of developing appropriate treatment for matters they observe, such as sending a reminder letter to plans which fail to include a Schedule A with a Form 5500, or plans with 100 participants which still file a Form 5500EZ.

   With non-filers, the first contact could be a letter simply noting that no return was filed and asking for a copy of the return. Similarly, taxpayers give a better reception to a brief phone call to the taxpayer before the first letter is sent, or a letter with softer language. Accordingly, we strongly recommend the use of "soft contact" letters where appropriate, to determine whether a particular compliance problem exists.

3. Manage Taxpayer Expectations. *Set expectations early and simply.*

We hear anecdotal comments from taxpayers who have heard nothing from the Service for six months, then are asked to respond to a document request in ten days, or who have negotiated a settlement only to find it overturned on review. We encourage TE/GE to clearly communicate expectations to taxpayers at the onset of the audit. Taxpayers should receive a brief letter in plain English, outlining the areas being audited (if it is a focused audit), the anticipated timeline, and the demands expected to be placed on the taxpayer. For large cases this might take the form of a much more extensive meeting or series of meetings to agree on an audit schedule. Whether the case is large or small, we encourage TE/GE to contact the taxpayer personally to discuss these expectations. We also encourage the EP division to develop a brief letter or statement detailing the rights and obligations of both the taxpayer and the IRS.

It's extremely important to actively communicate with customers about delays and gaps in the examination process. Taxpayers deserve to know when a case is being delays for some reason, or why there is a period of long silence. Leaving taxpayers in the dark and guessing about status is poor taxpayer relations and heightens the adversity in the relationship. (See also discussion below, concerning the use of on-line tools in Active Case Management.)

4. Cooperative Approaches. *We encourage TE/GE seek more cooperative approaches, and in particular to adopt a practice of entering into audit contracts of the type implemented by the Service's LMSB division.*

Our vision here is that TE/GE would have an initial meeting with the taxpayer, identify topics to be audited and expected document needs, and then agree with the taxpayer on a schedule for completing the audit. For example, the taxpayer would agree to provide information with respect to each audit topic by a specified date, with a commitment by TE/GE to close each audit topic within a certain period of time after all documents have been produced.

5. Advance Notice of Actions. *We encourage TE/GE to provide ample advance notice of actions, such as IDRs, on-site visits, or actions requiring taxpayer response.*

A formal IRS document request can require document production within ten days, which is often unreasonably short. Audits often arise a year or more after the period or event under audit, when memories are stale and materials have been shipped to off-site storage locations, and large taxpayers may have voluminous documents and storage boxes to search for relevant material. With pre-contact planning, and an audit plan negotiated with the taxpayer, TE/GE should be able give the taxpayer enough advance warning about document

needs to avoid last-minute IDRs. Opportunities should exist for the taxpayer and the IRS to arrive at reasonable time frames within which information can be requested and submitted. For small cases, this could be managed through a phone call and confirming letter, rather than something as formal as a negotiated schedule.

We recognize that goals of reducing cycle time will discourage extensions of time to respond to document requests. Agents should not be penalized for providing advance notice of document requests, or for providing reasonable extensions of time to respond to document requests given with no advance notice.

6. Closing Processes. *We recommend TE/GE simplify closing letters and actively communicate general findings.*

We encourage TE/GE to actively communicate findings more quickly and reduce the delay between the final on-site visit or substantive communication and the final closing letter. We believe most taxpayers look for a simple assurance at the close of the audit that everything is in order, or specific corrections which are required. The Service's characterization of "no change" or "some change" is meaningless to unsophisticated taxpayers.

7. Communicating Common Errors. *We recommend EP prepare and communicate to taxpayers "top ten" lists of common audit problems, and "red flag" facts that suggest possible underlying plan problems.*

We encourage EP to publicize common errors and risk areas in order to increase compliance. Something like a "Top 10" list of common problems found on audit would be a good way of raising taxpayers' consciousness. There could be multiple lists – one for each major industry segment, such as a "Top 10 401(k) problems", a "top ten 403(b) problems" and a "top ten" defined benefit plan problems. We also encourage EP to prepare and publish a "red flag" list of plan design features or facts which indicate risk of deeper underlying problems. For an example, see Appendix A.

REDUCING CYCLE TIME

"Cycle time" is defined by the IRS as the period between the date of an auditable event (such as filing of an informational return) and the date an audit is completed. From the taxpayer's point of view, the "cycle time" is measured from when the notice of audit is received to when the auditor is out-the-door and the letter of no action is received. Long cycle times generate taxpayer dissatisfaction and impede effective audits as memories become stale or documents become difficult to retrieve.

The current pattern is for employee plan years that are two or three years back to be selected for audit. This may involve recovering files from storage. A more up-to-date audit would be preferable. For example, does the IRS have to wait for the return to work its way through the IRS system? Service practice is to scan Forms 5500, but it currently it takes approximately 1 ½ years for scanned Forms 5500 to become available to auditors.

We endorse the efforts of the EP Exam Reengineering group to reduce cycle time, reduce the burden on taxpayers, and achieve better case selection. Some of our comments below are drawn from or in response to our understanding of the early efforts of this redesign team.

Below are a number of suggestions for reducing the length of time in a typical audit cycle.

1. Case Selection. *Employ techniques that focus examination selection on the most likely problem cases.*

The initial selection decision is an important step in audit efficiency. Careful case selection can minimize the amount of taxpayer and TE/GE time spent on audits which don't uncover any compliance failures. In the recent past, the percentage of employee plan audits closed without a change has equaled approximately 70%. We recognize the resources available to conduct audits are limited. We believe better targeting of cases for examination will further the goal of identifying and correcting non-compliance. We support EP's recent efforts to improve, refine and expand the use of the "risk assessment" technique for audit case selection. We encourage EP to continue to refine its risk assessment approach, and consider criteria such as whether specific industries have weaker compliance records, specific problems common in certain industries, the type of plan, past audit experience, 5500 errors, and specific vendor problems.

2. Pre-Contact Planning. *Plan the audit prior to any contact with the taxpayer.*

Before engaging with the taxpayer, TE/GE should make every effort to prepare for the audit. This could include careful review of information on the return, identifying and reviewing information available from other resources, reviewing the Internal Revenue Manual and relevant legal authority, determining audit scope, and preparing document requests where appropriate. During this pre-contact planning stage, TE/GE can consider whether a limited scope audit or correspondence audit would be more appropriate for the specific case. Part of this planning should include adequate time to request, receive and review documents prior to any on-site visits. This is also an appropriate time to consider agent selection, and whether the case might be suitable for agent training and development. To the extent that involvement of IRS Counsel may be important,

we encourage TE/GE to identify those issues during the pre-planning stage and coordinate with counsel's office to ensure timely turnaround on those issues. Initial data requests are often broad and cover a standard list of documents and information, sometimes requesting unnecessary documents or copies of materials which the Service should already have. We encourage the TE/GE require agents to prepare accurate and focused data requests.

3. Focused Audits. *Develop programs to expand the use of "focused" or "limited scope "audits.*

We also believe there are potentially greater efficiencies available through the expanded use of "limited scope" or "focused" audits – audits which target a select number of issues. By identifying a limited number of audit issues during the pre-contact planning stage, TE/GE can narrow the initial inquiry, leading to faster document production and faster resolution of those issues. A necessary companion to this is to prepare a narrow and targeted request for documents and information. While we recognize the TE/GE needs to retain the ability to expand the case to include other issues, we would recommend that any expansion beyond the initial limited scope be undertaken only with management approval.

We also recognize that newly hired agents may not have the experience to identify when a limited scope audit should be expanded. Rather than limit the focused audit approach to more senior agents, we would encourage TE/GE to prepare junior agents with proper training, and exercise closer supervision when a junior agent is assigned to a limited scope audit. One training aid might be a "Red Flag" list of ways to identify problems. (See example in Appendix A.) Such a list might also be useful to plans as well, to help identify problems and cure them well before an audit. It might be appropriate to have different lists for different plan types (403(b), 401(k), defined benefit, multi-employer), or even for different industries.

4. Different audit techniques for different case types. *Continue to apply alternate audit approaches, and in particular to implement joint agreements with taxpayers in large cases.*

Different audit approaches can and should be applied under different conditions. Variables such as the taxpayer's size, history or industry may warrant a different approach. It's often possible to handle small cases entirely through correspondence. We understand TE/GE recently established the Employee Plans Team Audit program, EPTA, aimed at plans with 2,500 or more participants. The key features of the program are planning, engagement, management involvement (IRS manager), and post-audit critique. We applaud the use of the team audit approach for large cases. For large cases, TE/GE should implement a program of negotiating audit schedules with the taxpayer,

implementing the cooperative approaches discussed above in the context of Communication with the Taxpayer.

5. Agent Selection. *Match cases to agents based on expertise, not geography, and actively manage agent inventory.*

Historically, agents have been assigned to cases in large part based on geographic proximity, following an audit model founded on site agent visits. As a result, agents may be auditing cases involving issues for which they have no experience, or beyond the agent's expertise. We believe audits will be concluded faster and with greater efficiency for both TE/GE and the taxpayer if the auditor has specific experience with the type of issues under audit. We recognize that matching the agent to the case may not always be possible within a single geography, and encourage TE/GE to carefully consider the opportunities to conclude an audit more efficiently, despite the additional travel costs of bringing in an auditor from another geographic area.

We encourage TE/GE managers to actively review and manage agent caseload. Regular review of an agent's caseload will help ensure that the cases continue to move forward expeditiously, and should allow the manager to identify problems in advance of overburdening the agent. An auditor forced to conduct too many audits simultaneously may be unable to move individual cases quickly, yielding low close rates and contributing to taxpayer dissatisfaction. In addition, as the case stretches out over time, the auditor will spend additional time reacquainting himself or herself with the issues each time new action is required. We also encourage TE/GE to keep inventory at manageable levels, to allow agents to work cases more frequently, reduce cycle time and thereby increase throughput and decrease customer dissatisfaction with long cycle times.

We recognize that auditors often gain expertise by being assigned to cases which require the auditor to learn new areas, and that this training objective may be in conflict with the objective of achieving efficiency by matching auditors to cases based on expertise. We encourage TE/GE to continue to support this training objective by carefully matching auditors to cases with growth opportunities, but under the guidance of a manager with the necessary expertise.

6. Agent Training. *Devote significant resources to training examination agents.*

The number of EP examination agents dedicated to processing examinations has increased from approximately 300 in 2003 to approximately 550 at the beginning of 2004. Encourage TE/GE to hire more In addition, the anticipated shift of EP personnel from the Rulings and Agreements group to the Examinations group will increase the number of agents new to examinations. We encourage TE/GE to devote significant resources to training new examiners during the period of transition. We also encourage TE/GE to work with outside resources to develop

training materials. Attorneys and accountants experienced in responding to audits may be among the best resources to help train new auditors.

7. Active Case Management. *Actively manage cases and caseloads by establishing guidelines and norms for the amount of time a case should take, monitor agents' progress frequently, and consider use of on-line tools and administrative staff to monitor time lines.*

We recognize that each case is different and may require different resource and time commitments. However, we believe that there should be enough common elements to set reasonable norms and guidelines for how long a case should take, particularly small cases or cases handled via a correspondence audit. We encourage TE/GE to establish guidelines and norms for the amount of time a case should take, and monitor agents' activities frequently and at a depth necessary to detect timeline problems well before the case starts exceeding the norms. We also encourage TE/GE to develop on-line status information, and make that available to the taxpayer and the taxpayer's advisor(s), such as through a PIN-controlled login. This would help improve cycle time management by giving the taxpayer an opportunity to monitor status, and would also enhance communications between TE/GE and the taxpayer. We recognize that this could develop into just another burden, and would encourage TE/GE to develop the system in a way which would allow it to substitute for existing tracking processes, and use it both internally and externally.

8. Coordination with EPCRS. *To the extent audit cycle time is improved by initiating audits early, EPCRS should be modified.*

EPCRS currently provides a different fee structure and process for plan defects identified on audit, compare to plan defects identified and corrected by the plan or plan sponsor. We recommend that EPCRS be modified to allow certain audit-identified problems to be handled without the higher fees and penalties. Typically, plan sponsors may not identify a plan defect until the next annual recordkeeping cycle. If an audit commences before that cycle is complete, the plan will have been denied the opportunity to rectify the problem through self-correction or a plan-initiated filing under EPCRS. We recommend that EPCRS be modified to state that allow corrections to be treated as taxpayer-initiated if the correction is in response to an audit which commenced within 18 months after the end of the plan year or if the taxpayer had already identified the potential problem and commenced an internal review within the 18-month period.

8. Access to Forms 5500. *We encourage EP to consider using outside services, such as freeerisa.com, to access and process return information quickly.*

Auditors may not have access to Forms 5500 for approximately 1½ years after filing, due largely to delays in the process for electronically scanning and disseminating the forms. We encourage EP to consider using outside services such as freeerisa.com, to process and access Form 5500 information. EP may also wish to consider commencing an audit based on a prior year return, and requesting the latest return from the taxpayer.

OTHER SUGGESTIONS

We have two other suggestions which don't directly affect communications and cycle time, but which we believe deserve mention here.

1. Audit practices should be consistent nationwide. We believe consistency is an important element of fairness in any examination program. For this reason, we recommend that EP continue to devote resources to publishing "Audit Guidelines" for use by agents and plan sponsors. These guidelines should be kept up-to-date, and ideally will allow taxpayers to conduct self-audits as well has help prepare for audits initiated by TE/GE.

2. Identify means to review third-party providers. We believe that on occasion the practices of third parties should be targeted in audit and compliance reviews, and remedies sought against those third parties. This is an aspirational objective, and one that may require legislation. Many taxpayers rely on vendors to manage significant parts of their programs. Smaller plans, and even many large plans, rely heavily on third party recordkeepers or recordkeeper-trustees to establish and operate their retirement plans. These taxpayers may have only superficial understanding of the requirements to which they are subject.

Competition pressures vendors to provide services as lower costs. Less scrupulous vendors will take advantage of the relative lack of experience of their clients by promising lower costs and providing limited or shoddy service, with the taxpayer bearing the responsibility for compliance defects.

When clients of a particular vendor are experiencing high rates of non-compliance, we believe that the vendor should be targeted for a review of the vendor's practices and policies, where the vendor's practices have created or contributed significantly to the problem.

For example, where a retirement plan recordkeeper provides distribution notices or 402(f) notices which are defective, some penalty should accrue to the recordkeeper, rather than to the unsophisticated plan sponsor who relied on the recordkeeper's expertise.

TE/GE can initiate a civil investigation under Section 6700 (promoter penalties) or Section 6701 (aiding and abetting penalties), make a referral to the IRS Office of

Professional Responsibility, or refer the matter to Criminal Investigation (CI). We believe TE/GE should consider using these tools more broadly, looking at systemic errors and patterns of poor compliance. We encourage TE/GE to train agents in use of these enforcement tools, and ensure that training is in place so that agents can take appropriate action.

Where EP has identified process defects, EP should work with the vendor to correct the process. Compliance is the objective, not punishment.

TAX-EXEMPT BONDS

General Overview of Tax-Exempt Bond Examination Process

A formal audit program for tax-exempt bond issues was not initiated until 1993 and was created in response to a General Accounting Office report[1], which criticized the Service for relying too heavily on self-enforcement of tax-exempt bond regulations. The GAO report directed the Service to develop a formal enforcement program for tax-exempt bonds and specifically required the Service to address possible abusive transactions in a timely manner.

An audit of a tax-exempt bond issue possesses unique characteristics.

First, the issuer of the bonds is not the taxpayer. In the event of a determination of taxability, the bondholders are responsible for the payment of taxes, not the issuer of the bonds. However, bondholders generally do not have any information to assist in the examination process. Instead, the issuer or the conduit borrower maintains all records relating to the bond transaction and the underlying legal documents. This creates a unique complexity to the audit process for TEB. To address this problem, the audit guidelines treat the issuer of the bonds as the taxpayer for purposes of performing an examination.[2] Issuers are entitled to administrative appeal, but in most cases judicial review of IRS determinations must still be initiated by bondholders. IRM Section 4.81.1.17 allows a judicial review of certain determinations under Code Section 150. As a practical matter, this means that it is extremely rare that any issues raised on an audit of tax-exempt bonds are ever reviewed by an independent third party.[3]

A second area of concern with respect to the audit of tax-exempt bond issues is the municipal bond marketplace reaction to an issuer's disclosure that an issue is under examination. One study[4] performed by an industry organization concluded that there

[1] GAO/GGD-93-104
[2] See IRM Section 4.81.1.11.
[3] Legislation would be required to allow issuers the ability to seek a judicial review of an adverse determination.
[4] The Bond Market Association: "Secondary Market Effects of Municipal Bond Tax Audit Disclosure" – August 20, 2002

can be a decrease in the market price of variable rate bonds, at least in the short-term, when the market has knowledge of an examination in process for a particular bond issue. It should be noted that this study was not conclusive as to the impact on fixed rate debt.

In response to this possible market reaction, TEB developed several versions of the audit notification letter that explains to the issuer the reason the issuer has been selected for examination. It identifies the selection as either being a random audit, an audit in response to certain information that has come to the Service's attention, an audit being conducted because the bond issue has certain structural components that the Service wants to examine (e.g., open-market escrow, guaranteed investment contract, etc.), or is a type of bond that the Service is trying to obtain more compliance information about the type of issue (e.g., student loan bonds). It is not certain whether this clarification of the audit selection in the notification letter has had any impact to market reactions, but we believe this was an appropriate and helpful change to the TEB examination process.

A third issue relates to the timing for starting the audit. Certain tax compliance matters, such as the structure of the bond issue, costs of issuance paid, and in many cases arbitrage restrictions, can be determined at the time the bonds are issued or within a few months after the date the appropriate Form 8038 is filed with respect to the bonds. Other tax compliance matters, such as the use of the bond proceeds and the use of the facilities financed with the bonds, frequently will not be auditable until several years after the bonds are issued and in many cases actions taken by the issuer 20 years after the date the bonds have been issued can cause the interest on the bonds to be included in federal gross income from the date the bonds were delivered. This timing issue can create problems for the Service in deciding when to initiate an audit on a bond examination and can create record retention and institutional memory problems for issuers and conduit borrowers, who may be required to maintain records for the entire 30-year life of a typical bond issue (plus six years) and who often will have no one around who remembers the facts relating to a particular bond issue.

Consistent with many other areas in TE/GE and in the IRS generally, TEB also has a manpower issue. There are between 12,000 –15,000 tax-exempt bond issues sold in the country annually. The TEB division generally has an average of 400 examinations in process at any point in time. Currently, there are less than 40 agents performing audits of tax-exempt bond issues.

Moreover, because of the complexities involved in examinations of bond issues, TEB only utilizes experienced agents. These agents are internally trained in a series of courses specific to tax-exempt bonds. New hires into TEB go through a three-to-four week course of initial training in the area. All agents also received technical examination training about bonds and receive ongoing specialty training with respect to areas of potential abuse or non-compliance.

Under current TEB practice, tax-exempt bonds are selected for examination from a number of sources, including: (1) referrals from third parties, (2) transaction features

previously identified by TEB personnel as having a higher likelihood of possessing abusive features (sometimes involving Section 6700 violations), and (3) random audit selection of a particular bond issue type or attribute.

In addition, TEB has undertaken a number of projects for the purpose of better understanding the compliance levels of a certain type of financing (e.g., single-family bond issues). TEB assigns agents to look at the defined transactions, develop check sheets to assist in establishing audit guidelines, and forward their findings to the Office of Outreach, Planning and Review (OPR). The agent(s) assigned to defined projects will generally write an article to be used as part of the training of TEB agents. OPR utilizes all of the information gathered from these defined projects to determine the best approach to encouraging issuer compliance.

The ACT has previously identified IRS audits as being a necessary component of encouraging compliance and self-correction.[5] The audit process performs at least a three-part role. First, the existence of an audit program, with appropriate penalties for noncompliance, provides additional incentive for users of tax-exempt bonds that are otherwise motivated to comply with the law to determine exactly what the rules are that are applicable to them and to try to satisfy those rules to avoid penalties. Second, the audit program gives the Service the opportunity to identify areas of noncompliance and seek to remedy those areas by either providing additional guidance (where the law is clear) or by seeking to have the rules clarified, either through issuance of regulations or rulings or through sponsorship of legislation (where necessary). Third, the audit program can be used to identify and select for appropriate treatment those few individuals who operate either with reckless disregard or with intentional disregard to existing law. Section 4.81.1.2 of the Internal Revenue Manual states that the goals of the tax-exempt bond examination program are to achieve significant levels of pre- and post-issuance compliance, respond promptly to abusive transactions, increase the effective use of informational returns, encourage transaction participants to take an active role in ensuring that their bond issue comply with the law, and promote voluntary compliance. We continue to believe that the "feedback" role of the examination program—to identify areas of noncompliance to direct educational initiatives and to help determine where the law needs to be developed more fully—remains a vital part of the program.

At the same time that the audit program is helping to accomplish these positive goals, the audit process can have negative effects. The audit itself may often be an extended process, where the entity being audited may have little idea as to what to expect as to the time involved and the issues being audited. During the course of the audit, there may be extensive periods of time during which there is no contact with the agent and the issuers or conduit borrowers may have no idea what is going on at the IRS on their cases.

In addition, the uncertainty on the part of the audited entity can be exacerbated by the knowledge of the issuer that it may have little recourse in the event of an adverse determination by the agent. As mentioned above, the Internal Revenue Manual treats

[5] General Report of the Advisory Committee on Tax Exempt and Government Entities dated June 21, 2002.

issuers as taxpayers for purposes of examination. In addition, beginning in September 1999, issuers were given the ability to request an administrative appeal of a proposed adverse determination to the Office of Appeals.[6] However, once the audit is complete, the issuer has no obvious method of obtaining a review of an adverse determination outside of the Internal Revenue Service (e.g., a court review of the result). In certain cases conduit borrowers may be also be treated as taxpayers (for example, under section 150(b) or section 168 of the Code) allowing for a collateral review of the adverse determination as to the status of the interest on the bonds. However, the issuer generally does not have the right to have the tax status of the bonds reviewed by a third party. Accordingly, where the experience of the issuer in the audit is poor, the issuer may be less inclined to be comfortable with a review of the audit internal to the IRS.

Suggestions for Improving the Audit Process:

The efficiency of the TEB audit process, the effectiveness of the auditor, and the experience of the audited issuer or conduit borrower can be improved by better communication between the auditor and the issuer and by managing the cycle time of the audits. This report suggests some tools that can be used toward this end. Some of these tools have been at least partially implemented by TEB, while others have been borrowed from practices either already in use or being considered by other divisions. We commend TEB for implementing some of these practices and encourage a wider acceptance and development of these tools.

A. Communication with Taxpayer[7]

1. Treat conduit borrower as taxpayer for purposes of audit.

Because of the nature of tax-exempt bonds, the only true taxpayer involved in most transactions is the owner of a tax-exempt bond. The IRS has long recognized that the owner of a tax-exempt bond is unlikely to have most or perhaps even any of the information relating to whether the bonds qualify for tax exemption and is unlikely to have the resources to marshal information relating to any legal theories involved with respect to a bond issue. Accordingly, the Service determined some years ago to treat the issuer of the bonds as the taxpayer for purposes of the examination.[8] This treatment is necessary to allow the examination process to obtain any useful information.

In many cases, however, the issuer simply acts as an accommodation party in issuing the tax-exempt bonds and the real user of the bond proceeds—and the person possessing the facts necessary to determine compliance—is the "conduit borrower." In addition, in most cases the conduit borrower has undertaken to maintain the tax-exempt status of the bonds and has indemnified the issuer against any tax problems. Thus, in

[6] Revenue Procedure 99-35.
[7] Because the issuer is treated as a taxpayer for purposes of a TEB audit, this paper will refer to issuers as "taxpayers."
[8] Announcement 95-61. See IRM Section 4.81.1.11.

cases involving conduit borrowers, it would appropriate for the examining agent to be dealing directly with the conduit borrower rather than the issuer.[9]

Accordingly, we would propose that TEB adopt a rule that would treat the conduit borrower as the taxpayer for purposes of the audit. This could be done by amending the Internal Revenue Manual, if possible. In addition, it would be appropriate to amend the Form 8038 to ask for the name, address, and TIN of the conduit borrower and for a contact person or contact position at the conduit borrower (in all cases except for the portfolio financings accomplished using student loan bonds and single family housing bonds). We understand that this suggested change is already in process in connection with the revisions of Form 8038.

2. Opening contact; manage the issuer's expectations by discussing timelines and the audit plan.

At the request of issuers, investment bankers, and the bondholder community, TEB has developed three forms of initial contact letters. These contact letters are designed to inform the issuer as to general reason the bonds have been selected for audit so the issuer may meet its on-going disclosure responsibilities.[10] Unfortunately, however, neither the initial contact nor any later stage of the audit includes a discussion with the issuer as to what to expect from the audit. Because issuers have not historically been subject to audit, they may have unreasonable or unrealistic views as to the scope and the timetable for the audit.

It is important to manage the issuer's expectations to keep the issuer from becoming frustrated with the process of the audit. We recommend that the issuer be given an outline of the expected course of the audit, including estimated timelines. Obviously, the audit may vary from that outline as the case develops. However, by providing an initial outline to the issuer and keeping the issuer up to date as timeline or scope changes, the Service can forestall issuer concerns that arise from unrealistic expectations.

Under the IRM, agents involved in the TEB examination program are to perform pre-examination research and prepare a comprehensive audit plan.[11] The audit plan might be a good starting place for developing a plan or outline that could be shared with the issuer or the conduit borrower. The form of the outline could either be in written material contained in the initial contact letter or in the first IDR or could be presented at an "opening meeting" or conference call designed to set expectations.[12] To the extent

[9] In the case of so-called "blind pools," where the conduit borrowers have not been identified at the time of the closing, the Service should continue to conduct the examination directly with the issuer.
[10] See IRM Section 4.81.1.14.1 and the sample letters contained in Exhibits 4.81.1-3, 4, 5, and 6 to the IRM.
[11] IRM Sections 4.81.1.12 and 4.81.1.13.
[12] We understand that in some cases EP has been considering or experimenting with an "audit contract." TEB may want to explore the success of such a procedure to see whether it could be adapted to tax-exempt bonds.

that particular legal or factual issues will be involved in the audit that can be identified at the time of initial contact, these could be conveyed to the issuer at that time.

3. Keep taxpayer advised as to timing for next step.

From the point of view of the issuer or conduit borrower, the audit process sometimes seems to be poorly focused and completely open-ended. Frequently, several months pass between communications from the IRS. Additionally, there may be several Information Document Requests (IDRs) requested every few months along the way. The IDRs contain specific deadlines by which the issuer should respond (although the agents will fairly readily allow an extension of those deadlines), but the issuer has no idea what the schedule of the agent is, ~~or~~ when the next IDR might be received, or how many IDRs may be issued. To the issuer, this process can be very frustrating.

We recommend the Service provide the taxpayer with an initial overview of the audit process as a means of establishing expectations for the taxpayer as to how the examination will progress. In addition to providing a general audit plan or overview of the process, another way to improve the examination process for the issuer would be to give the issuer some idea of when responses or additional inquiries will be coming from the agent. It may not always be possible to establish absolute deadlines, but giving the issuer some idea of when it will next hear from the agent will at least reassure the issuer that the agent is actively working the case. We believe that increased communication with the taxpayer will reduce uncertainty, tension, and frustration and will improve the overall effectiveness of the examination.

B. Reducing Audit Cycle Time.

One concern shared by both the IRS and the issuers is the amount of time involved in conducting an examination of a tax-exempt bond issue. The Service has established a goal of trying to reduce audit "cycle time."[13] Issuers (and bondholders), similarly, are interested in bringing any examination and the concomitant disruption in its affairs and the market for the bonds to a close as quickly as possible. The ACT fully endorses the goal of reducing audit cycle time, although we agree with comments made by the Director of TEB to us to the effect that the goal of decreasing audit cycle time should not take priority over performing an appropriate examination and resolving violations of the tax law. In particular, in intentionally abusive situations, we believe that it is more important to "solve the problem" and send a message to potential abusers than to try to bring the examination to a swift conclusion.

[13] The Service often refers to cycle time as the time from the filing of the return until the completion of the examination. As described above, where tax-exempt bonds are involved, it may be necessary to delay the start of the audit for some time to allow the facts to develop. Accordingly, from the issuer's point of view, a more useful measurement is the time of the "intrusion" of the audit—that is, the period that starts with the receipt of the opening examination and that ends with the closing letter or the signing of a closing agreement by all parties. For purposes of tax-exempt bond audits, we will refer to the cycle time in the latter sense. This is consistent with how cycle time is measured by TEB.

With that in mind, however, we have a number of suggestions that we believe would help to move examinations along more quickly. TEB has already identified some of these problem areas and has taken initial steps to improve cycle time. We commend TEB for taking these initial steps, and encourage further development in these areas.

1. Selection of cases.

In our discussions with the Director of TEB, one of the primary problems identified with the TEB examination program is the difficulty of understanding the complex structures of tax-exempt bond issues and applying what may often be multiple sets of rules to the details of the transaction. We agree that tax-exempt bond transactions can often be complex and one transaction may vary from another seemingly related transaction by a myriad of details. It takes substantial training and experience to learn to quickly separate the important variations in a transaction, the variations that may actually have a tax law impact, from the multitude of other variations that may be important for business reasons but may not have any tax law impact. The next two recommendations are designed to try to develop greater expertise among the agents.

TEB has established procedures for the selection of cases.[14] In large part, these procedures focus on various information gathering projects, compliance initiatives, and referrals. As a result, an agent starting to work on an audit may have little or no experience in the particular rules applying to those types of bonds. In addition, there may not be adequate training materials available relating to the particular type of bond issue being audited. The consequence of this lack of knowledge, either individual or institutional, can result in an extended examination.

Although TEB should not solely select for examination bond issues that involve information or expertise that it already possesses, to the extent that cases are selected for which TEB has developed adequate training materials or are related to subject matters which the agent already knows about, the audit process can be accelerated. According to the director, TEB has recently considered one of the early steps in initiatives involving information gathering to be the development of training materials relating to that topic. We encourage TEB to continue to develop training materials early on when it undertakes examination of a number of related bond issues. In addition, as experience develops from those audits and agents learn how to best approach an examination of a particular type of bond issue, that knowledge should be incorporated into the training materials to shorten future examinations.

We recognize that case selection is also dependent on the number of available agents to perform examinations. Currently, TEB has less than 40 field agents to perform examinations. There are also a significant number is potential cases identified for examination, including many cases which might be considered abusive transactions. Since the GAO issued a directive to focus on abusive transactions in a timely manner, most of the available TEB agents are assigned cases involving a potential abuse.

[14] IRM section 4.81.1.5.

2. Assignment of agent.

In addition to developing the training materials relating to particular topics, it is important to develop the individual expertise of the agents. In the private sector, the expertise of the individual practitioner is honed by working on several related matters. For example, the same tax associate might be assigned to several multifamily housing transactions in a relatively short period of time. In this manner, the associate develops skills to identify and resolve potential issues in a relatively short timeframe.

Similarly, TEB should be encouraged to develop the expertise of individual agents by assigning agents who have completed audits involving a particular type of bond issue similar bond issues. TEB is using its Special Training program to develop expertise in particular areas. We believe this is an extremely valuable program, and TEB is encouraged to continue this program and develop it further. Pursuant to the IRM, Field Group Managers are delegated the responsibility of assigning cases to field agents.[15] Field Group Managers should be encouraged (to the extent they are not already doing so) to take into account the prior experience of agents in making their assignments.[16] In addition, field agents should be encouraged to speak with other agents who have audited similar issues

3. Pre-contact planning phase.

The IRM states that an agent should normally perform pre-examination research on every case to avoid or reduce the potential market impact of an examination.[17] In addition, pre-contact research and planning can reduce the time for the examination if the agent takes the opportunity to prepare him or herself for the examination. The agent should be encouraged to review not only any IRS training materials relating to the subject matter of the investigation, but also the particular requirements set forth in the sections of the Code and regulations involved in the financing. In addition, an agent may find it useful to refer to materials published by third parties relating to that type of financing. A useful source, for example, would be referring to copies of the textbook from NABL's annual Bond Attorneys Workshop. Often, the BAW textbook will contain outlines relating to the specific issues raised with a particular type of financing. Other resources from NABL can be useful, such as the outlines from the Arbitrage or Tax Seminars or Institutes. (We understand from discussion with the Director of TEB that the last part of this recommendation was implemented during 2003 when TEB purchased the Bond Attorneys Workshop books for internal training purposes.)

[15] IRM Section 4.81.1.5.3.2.
[16] IRM Section 4.81.1.9.1.1 specifically states that the group manager will assign cases to agents taking into account the experience of the agent. Group managers should be encouraged to take into account not only the overall amount of experience of agent, but also the specific experience of the agent with related cases.
[17] IRM Section 4.81.1.12.

4. Consider narrow scope of examination.

In some cases, an examination may be opened to focus on a particular identified substantive issue, rather than a more broad inquiry relating to all tax issues that could relate to the bond issue. Where the Service has identified a particular recurring compliance issue, such "narrow scope" examinations should be encouraged in the place of the "soup to nuts" examination. A sufficiently focused examination should proceed substantially quicker than a broad examination.[18]

TEB has undertaken these narrow examinations in the past. For example, a large number of examinations are done focusing solely on arbitrage issues.[19] Similarly, TEB has done focused examinations of solid waste disposal facility bonds, looking at whether the definition of "solid waste" is met, and is undertaking a series of examinations of advance refunding bond issues that involved the sale of "escrow puts" by the issuer.

It should be noted, however, that as with all examinations, the narrowly focused examination can be substantially bogged down if the examination is into an area where the law is not yet settled. If the examination process unearths substantial issues related to unsettled law, it is important that the law be clarified in a principled manner that is satisfactory to both the IRS and to the industry. For this reason, where unsettled areas are found, we recommend that the Chief Counsel and Treasury, if necessary, become involved to provide additional guidance. A recommendation by TEB that particular issues be resolved by regulation or other published guidance would be perceived by the bond industry as evenhanded enforcement.

On the other hand, to the extent that the law is settled and on-going compliance problems are identified, TEB should be encouraged to use the narrow examination route more frequently.

5. Case management.

One important tool to encourage a timely audit process is case management by TEB. Under the current guidelines, quarterly reports are made by each group manager relating to on-going examinations.[20] This procedure is designed to provide information to TEB management relating to the process of cases. We endorse a reporting procedure, and believed it can be enhanced by providing additional parameters.

- Estimates should be made as to how long a particular examination will take when the examination is opened. The estimate should be consistent with the audit plan conveyed to the issuer at the opening of the examination. Progress reports can be measured against these estimates and, if necessary, the estimates can be revised. If the examination is

[18] We have been informed that EP is exploring using a similar "narrowed scope" examination process.
[19] In many cases, arbitrage issues can be also relatively easier to audit once the basic arbitrage questions are understood.
[20] IRM Section 4.81.1.26.

delayed and the schedules are revised accordingly, management of TEB should know why the examination is delayed and use that information to identify particular problems with the original estimate, with the particular bond issue under examination, or with the expertise of the agent.

- With enhanced scheduling information, both group managers and the Director will be better able to "stay on top" of the agents. When cases are delayed due to training or expertise issues, it should be easier to identify those issues and to take curative measures.

- Finally, it is important that case management issues be delegated to positions that require less substantive skills (such as administrative assistants or secretaries) unless and until there are problems that result in substantial delays. That is, where systems are working as expected, it should not be necessary to bring management into the picture. This should give managers more time to use their skills to manage problems.

6. Closing procedures.

One anecdotally reported complaint among issuers who are audited is the time it takes to close an examination. In some cases, a letter closing a case with no change may be received months after the last contact with the Service. When a case is closed through a closing agreement, it may be months after the closing agreement is signed before the issuer receives formal notification of the closing of the case. This delay in bringing what is thought to be a closed matter to completion can be very frustrating to an issuer, particularly where the pendency of the examination has been disclosed to the public by the issuer in order to comply with SEC rules or with good disclosure practice.

The case closing procedure is spelled out at some length in the Internal Revenue Manual, at Section 4.81.1.32. We encourage TEB to examine the closing procedures in some depth to see what can be done to make the closing process smoother. In addition, more priority should be given to getting cases actually closed in a timely manner.

7. Issues beyond the control of TEB.

A number of other issues that are beyond the control of TEB contribute to a slower audit cycle. In large part, these boil down to resources problems. The staffing level of TEB is currently about 60% of the suggested staffing level and is down to about 70-75% of recent staffing levels. Often there is a substantial delay in getting technical advice from the Chief Counsel's office; again, additional staffing at the Chief Counsel's office could help with this bottleneck. We encourage the review of resources and consideration of allocation of additional personnel to TEB and the Chief Counsel's office.

8. Soft Guidance – Reporting Findings.

We believe that educating the issuer community to the types of errors found during examinations of tax-exempt bonds that have a positive impact on future errors by other issuers. We recommend TEB develop a "Top 10" listing (or similar title) detailing the nature of the errors encountered during tax-exempt bond examination to be used as a training tool for agents. This list can be incorporated into the CPE material published on the TEB web site thereby providing an education tool for the entire tax-exempt bond community.

9. Records retention as an audit issue.

Finally, although not directly related to audit cycle time, a particular audit issue that has become very important to issuers is records retention. For bonds to be tax exempt, various rules must be complied with over the life of the bond issue. The issuer must identify how the bond proceeds were spent or to what particular expenditures the proceeds were allocated. The issuer needs to keep records as to investment of all proceeds prior to expenditure, including records as to investments and expenditures from any reserve funds or debt service funds. The issuer needs to show how any financed facilities were used over the life of the bond issue, including rentals of space in bond-financed facilities, management contracts, sales of output, and the like. For particular types of private activity bonds, the conduit borrower or issuer may need to keep specific records—for example, for a multifamily housing project, records need to be kept on the incomes of tenants and the rental of units. Over a thirty-year bond life, the volume of the original records that need to be kept can become enormous.

In addition, because of turnover at the issuer or conduit borrower, the institutional knowledge relating to the bonds and the bond-financed projects may become diluted or lost. Even if records are kept, it may become difficult or impossible to identify the importance or location of the records.

The costs of maintaining the records and the institutional knowledge can become quite burdensome. Issuers have been complaining for some time about the costs and burdens of record retention. The records retention problem becomes especially acute in the context of an audit, where it is quite common for the agent to issue an IDR asking for records relating to all expenditures of bond proceeds. Although an issuer may have available trustee records, those records often are not accurate or reflect expenditures that on a "direct tracing" basis are different from the allocated expenditures made by the issuer under Treasury Regulation §1.148-6.

The committee believes that the Service must take steps to address the records retention problem. One possible solution, suggested in our VCAP report, is to provide for a "self audit" (either internal or external), after which only the audit needs to be kept and the primary source material may be discarded after a reasonable period of time. This is similar to plan sponsors being required to obtain an audit in connection with the filing of Form 5500. Issuers of tax-exempt bonds could be given the option of an audit of the related records of a bond issue.

Other solutions may be available, and we highly encourage TEB to contact various industry groups, such as GFOA, and work with Chief Counsel's Office and Treasury to develop a more formalized program to simplify the record keeping the requirements. Such a program would help to make the examination process more efficient from the Service's point of view and less painful from the point of view of the issuer.

APPENDIX A

401(k) "Red Flag" List

Sample "Red Flag" list for a 401(k) Plan. Such a list could include issues which can be identified with some general information about the plan sponsor and a review of the plan document and summary plan description.

1. Compensation Definition

Definition of Compensation for purposes of applying deferral elections ties to W-2 compensation, and the plan sponsor has a stock purchase plan or broad-based stock option plan.

Equity compensation plans typically generate W-2 income on exercise of stock options or early sales of stock purchased through a §423 stock purchase plan. A plan which permits employees to make 401(k) deferrals from such income may not have any means to collect the deferred income, and therefore would be applying the deferral percentages incorrectly.

2. Definition of Eligible Employee

The plan does not exclude persons classified by the employer as non-employees, and the employer hires temporary employees and "independent contractors".

Many plans exclude so-called leased employees, but may not exclude persons classified by the employer as non-employees. A company which hires large number of temporary employees and "independent contractors" may in fact have many common law employees who are misclassified. Broadening the audit to encompass an examination of such persons designated as independent contractors may in fact uncover common law employees who have been improperly excluded, or former leased employees who are entitled to past service credit after having been hired as regular employees.

3. Deferral Percentage Tests

The plan does not provide for matching contributions and does not limit the percentage which may be deferred by Highly Compensated Employees.

Many plans pass the average deferral percentage test by limiting the contributions of highly compensation employees, or encourage higher contributions by Non-Highly Compensated Employees through the use of matching contributions. Other plans may return excess contributions, or make supplemental non-elective contributions in order to pass the ADP test. If a plan has no limits on HCE deferrals and no matching contributions, broadening the audit to examine how the plan meets the ADP test may uncover a process inadequacy.

Advisory Committee on
Tax Exempt and Government Entities
(ACT)

V. The "*RIPPLE*" Project

Reviewing **I**RS **P**olicies and **P**rocedures to **L**everage **E**nforcement:
Recommendations to Enhance Exempt Organization's (EO) Enforcement and Compliance Efforts

"If we do not act to guarantee the integrity of our charities, there is a risk that Americans will lose faith in and reduce their support more broadly for charitable organizations, damaging a unique and vital part of our nation's social fabric."

IRS Commissioner Mark W. Everson
March 30, 2004

Karl Emerson, Project Leader
Ann Bittman
Victoria Bjorklund
Deirdre Dessingue
Sara Meléndez
George Vera

June 9, 2004

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I. EXECUTIVE SUMMARY

Over the past decade, the number of exemption applications filed with the IRS's Exempt Organization Division (EO) has steadily increased each year and reached an all-time high of 91,439 in 2003. As a result, there are now over 1,640,949 exempt organizations and over 964,418 of these have been granted 501(c)(3) status as either public charities or private foundations. Even though the number of organizations granted exempt status has increased dramatically over the years, EO staffing levels have remained essentially static.

To deal with the ever-growing number of determination requests, over the last several years examination personnel have been reassigned to the determination process so that these requests for exempt status could be evaluated in a more timely manner. Even though this reassignment of personnel ceased sometime ago, it has resulted in the percentage of the EO workforce devoted to the determination function reaching historically high levels, while leaving significantly fewer employees dedicated to the examination function. In fact, partly because of this reassignment of personnel, EO's examination rate has, for some time now, fallen below 1 percent.

With such a low examination rate, it is widely believed that the current EO compliance presence is not sufficient to guarantee appropriate attentiveness by the exempt organization community or to engender confidence among contributors and others that credible oversight of the sector exists. In fact, during the last several years, many articles in both the mainstream press and specialized publications for the exempt organization community have questioned the ability of both state regulators and EO to monitor the exempt sector effectively. In addition, two years ago the General Accounting Office (GAO) concluded in a highly-publicized report that both state regulators and EO were not doing an adequate job of overseeing the sector.

Given this widespread perception of insufficient state and federal oversight of the exempt sector, it is imperative that EO explore ways to enhance its enforcement and compliance efforts so that public confidence in both EO's effectiveness and in the exempt sector itself can be increased. The public's confidence in, and support of, the sector increases when it perceives there is effective monitoring and oversight by state and federal regulators, and decreases when it perceives that monitoring and oversight are minimal and ineffective. As a result, state regulators and EO each play vital roles in maintaining confidence in the exempt sector. EO plays a particularly important role because it is the governmental entity responsible for ensuring that only qualified organizations are granted, and retain, exempt status. In this capacity, EO plays a crucial "clearinghouse" role in helping assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

Our recommendations are intended to help EO enhance its enforcement and compliance efforts by increasing its "presence" in the exempt organization community. This objective is consistent with one of the primary objectives of IRS Commissioner Everson to enhance the overall effectiveness of IRS enforcement and compliance in all areas of responsibility. As EO implements each of our recommendations, there will be an ever-widening "ripple" effect throughout the exempt organization community as EO's enhanced enforcement and compliance efforts become more widely known. As each recommendation is implemented, both the reality and perception that EO is more effectively overseeing the sector will increase --- much like a single stone tossed into the water has an ever-widening or "ripple" effect on the water into which it is thrown.

As will be seen from many of our recommendations, EO will be able to enhance its enforcement and compliance efforts by utilizing technological advances and other means to help its staff work more effectively and efficiently. However, given the explosive growth of the exempt sector over the last several decades, there is no getting around the fact that significant staff increases will also be required if EO is to do a truly credible job of overseeing this rapidly-expanding and vital sector of our economy.

Therefore, with the ultimate goal of increasing public confidence and trust in the exempt sector, we offer the following recommendations to enhance EO's enforcement and compliance efforts:

EXAM-RELATED RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to effectively select for more detailed review those organizations that are likely to be noncompliant or otherwise violating the law. Therefore, EO should improve its case selection efforts and develop an ongoing feedback process for continuous refinement of its selection criteria. In addition, EO should increase the number of "limited scope" audits and targeted "soft contacts" within the exempt organization community.

PUBLICITY-RELATED RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to effectively publicize the results of its enforcement efforts and the types of compliance issues about which it is concerned. Therefore, EO should improve publicity regarding its enforcement efforts and compliance concerns. In addition, EO should publicize widely the availability and advantages of electronic filing of Form 990 and encourage exempt organizations to utilize this option.

STAFF-RELATED RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to recruit and retain sufficient numbers of well-trained, experienced staff to conduct its oversight responsibilities. Therefore, the IRS should follow through with its commitment to hire 72 additional EO examination agents and should improve

and enhance its current training and education programs for agents and examiners.

PUBLIC EDUCATION RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to regularly educate the organizations it oversees so that the organizations can ensure they are in compliance with all applicable laws, rules, and regulations. Therefore, EO should increase its issuance of technical and precedential guidance and increase the number and technical content of its public presentations and other educational initiatives.

CONSEQUENCE-RELATED RECOMMENDATION: An essential element of any oversight agency's enforcement and compliance program is its ability to encourage compliance by regularly documenting and pursuing significant violations of the laws, rules, and regulations the agency is responsible for enforcing. Therefore, EO should increase the consequences for both individuals and organizations that intentionally submit false Form 990 returns or otherwise violate the law.

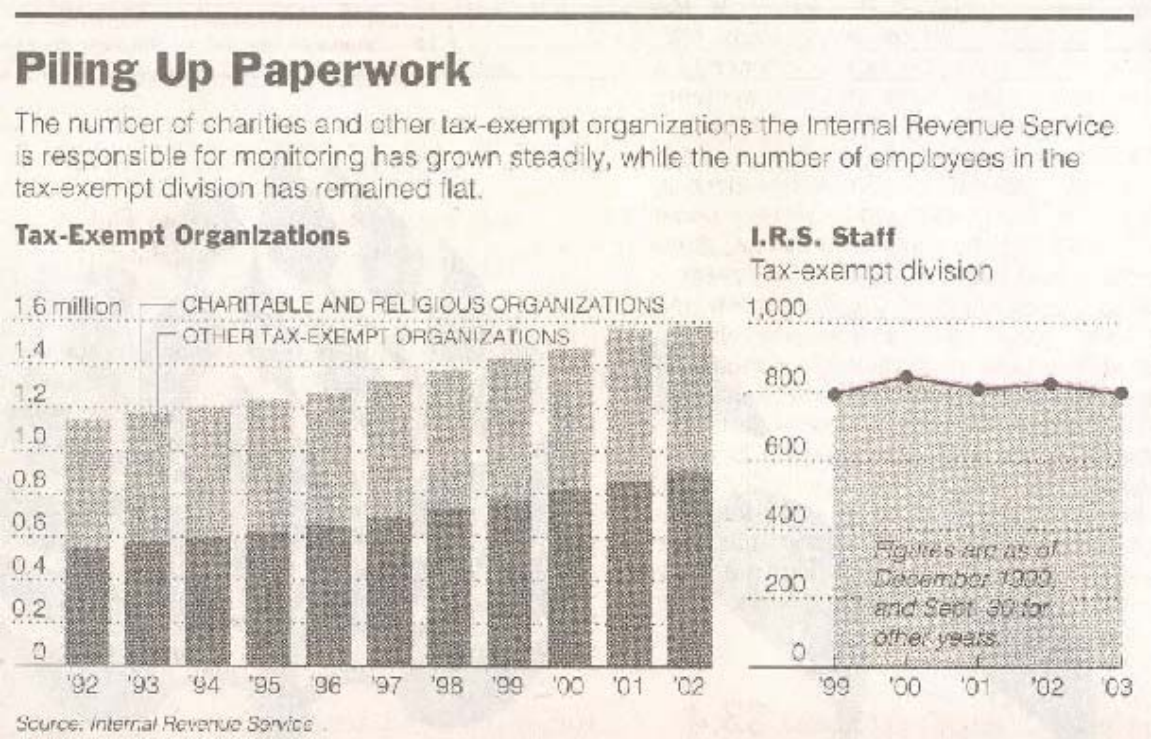
ENFORCEMENT-RELATED RECOMMENDATIONS: An essential element of any oversight agency's enforcement and compliance program is its ability to encourage voluntary compliance and to coordinate its efforts with state and federal agencies that have similar enforcement responsibilities. Therefore, EO should implement a formal voluntary compliance program and vigorously support amendment of Section 6103 of the Internal Revenue Code.

II. BACKGROUND

At our June 21, 2002 public meeting, we recommended installation of Life Cycle of a Public Charity and Life Cycle of a Private Foundation webpages on the IRS website as a means of providing access to narrative explanations and applicable forms and instructions relating to significant events in the "life" of a charity. At our May 21, 2003 public meeting, we offered a range of recommendations to improve the EO determination process. Some of these recommendations, notably the development and posting of a fully interactive Form 1023 ("CyberAssistant"), were logical extensions of our earlier Life Cycle recommendations. In our May 2003 report, we expressed our belief that streamlining the EO determination process would enable EO to increase its focus on compliance, an essential function in maintaining the integrity of the exempt sector.

Over the past decade, the number of exemption applications filed with EO each year has steadily increased. It reached an all-time high of 91,439 in 2003. There are now over 1,640,949 exempt organizations and over 964,418 of these have been granted 501(c)(3) status as either public charities or private foundations. The following charts show that, even though the number of organizations granted exempt status has increased dramatically over the years, EO staffing levels have remained essentially

static.



To deal with the ever-growing number of determination requests, over the last several years EO management has reluctantly reassigned examination personnel to the determination process so that the voluminous requests for exempt status could be evaluated in a more timely manner than would otherwise have been possible. This reassignment of examination personnel ceased in February of 2003. However, the earlier reassignments resulted in the percentage of the EO workforce devoted to the determination function reaching historically high levels, while leaving significantly fewer employees dedicated to the examination function. In fact, partly because of this reassignment of personnel, EO's examination rate has, for some time now, fallen below 1 percent.

In a voluntary tax system, compliance must necessarily rely upon perception and deterrence, with appropriate oversight by both federal and state regulators. Even though most individuals and organizations comply with the tax laws because it is "the right thing to do", the unfortunate reality is that many "voluntarily" comply only because they believe that, if they don't, there is a substantial likelihood they will eventually get caught and have to pay significant penalties. With an examination rate below 1%, it is widely believed that the current EO compliance presence is not sufficient to guarantee appropriate attentiveness by the exempt organization community or to engender confidence among contributors and others that credible oversight of the sector exists. During the last several years, there have been many articles questioning the ability of

both state regulators and EO to monitor the exempt sector effectively.[1] For example, according to a recent *New York Times* article:

> *"America has the world's biggest collection of charities, but oversight of the nonprofit sector is parochial, piecemeal, political and, at times, accidental. In the last decade, gaps in a regulatory system that could be described as more hole than net have widened, as the number of charities and their assets exploded and state and federal money spent monitoring them remained flat or declined."*[2]

This is typical of the kind of publicity state regulators and EO receive concerning their enforcement efforts in both the mainstream press and specialized publications for the exempt community. In addition, two years ago, the U.S. Senate Finance Committee asked the General Accounting Office (GAO) to conduct a detailed review of EO's effectiveness in monitoring and overseeing the exempt sector. In its highly-publicized April 2002 report, the GAO concluded that both state regulators and EO were not doing an adequate job of overseeing and policing the sector.[3]

Given this widespread perception of insufficient state and federal oversight of the exempt sector, it is imperative that EO explore any and all ways to enhance its enforcement and compliance efforts so that public confidence in both EO's effectiveness and in the exempt sector itself can be increased. Numerous surveys, studies, and articles have recently chronicled a significant decline in donor confidence that, if not addressed and reversed, could have serious, long-term consequences for the sector.[4]

It is critical that the public feel confident that the exempt sector is comprised of legitimate, fiscally-prudent, and accountable organizations that provide valuable services. The public's perception of the sector must be positive to ensure continued support. The entire sector is tarnished whenever there are scandals or serious questions about the integrity, credibility, or effectiveness of certain exempt organizations. Indeed, Independent Sector, the largest membership group for exempt

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[1] See, "A Challenge for the IRS", *The Chronicle of Philanthropy*, Volume XIII, Number 21, August 23, 2001.

[2] "New Equation For Charities: More Money, Less Oversight", *The New York Times*, November 17, 2003.

[3] "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities", GAO Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, GAO-02-526.

[4] See "Nonprofits Show Losses in the Public's Trust", *The Washington Post*, September 10, 2002; "42% Of Americans Say Relief Effort Damaged Faith In Nonprofit Groups", *The Chronicle of Philanthropy*, September 5, 2002; Paul C. Light, "Trust in Charitable Organizations", a Brookings Institution policy brief published in December 2002; "Public Confidence in Charitable Organizations Continue to Lag, Report Finds", *The Chronicle of Philanthropy*, December 11, 2003, page 27; "To Give or Not to Give: The Continued Crisis in Charitable Confidence", a Brookings Institution policy brief published in December 2003, www.brookings.org ; "Survey Identifies Troubling Trends for Nonprofit Organizations", *The Chronicle of Philanthropy*, November 14, 2002.

organizations in the United States, has correctly noted that, "[p]ublic trust is the single most important asset of the [exempt] community. Without it, donors will not give and volunteers will not get involved."[5] As the opening quotation to this report indicates, IRS Commissioner Mark W. Everson shares this view.

Equally important, the public's confidence in, and support of, the sector increases when it perceives there is effective monitoring and oversight of the sector by state and federal regulators, and decreases when it perceives that monitoring and oversight are minimal and ineffective. As a result, state regulators and EO each play vital roles in maintaining confidence in the exempt sector. EO plays a particularly important role because it is the governmental entity responsible for ensuring that only qualified organizations are granted, and retain, exempt status. In this capacity, EO plays a crucial "clearinghouse" role in helping assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns[6]; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

Because we believe public trust and confidence in the exempt sector needs strengthening, our recommendations are intended to help EO enhance its enforcement and compliance efforts by increasing its "presence" in the exempt organization community. This objective is consistent with one of the primary objectives of IRS Commissioner Everson to enhance the overall effectiveness of IRS enforcement and compliance in all areas of responsibility. As EO implements each of our recommendations, there will be an ever-widening "ripple" effect throughout the exempt organization community as EO's enhanced enforcement and compliance efforts become more widely known. As each recommendation is implemented, both the reality and perception that EO is more effectively overseeing the sector will increase --- much like a single stone tossed into the water has an ever-widening or "ripple" effect on the water into which it is thrown.

III. PROJECT FOCUS

The decision to focus our third EO project on the EO examination process is a logical progression from our two previous EO projects. Because it appeared at the

[5] "Obedience To The Unenforceable: Ethics and the Nation's Voluntary and Philanthropic Community" (2002), Independent Sector, www.independentsector.org.

[6] Form 990 returns are detailed annual informational returns that report an organization's revenue, expenses, and other key operational information. Most exempt organizations are required to file a Form 990. These annual returns are public documents and include: Form 990s that are filed by the majority of exempt organizations, Form 990EZs that are filed by exempt organizations with annual revenues under $100,000, and Form 990PFs that are filed by private foundations.

outset of this particular project that EO enforcement staffing levels were not likely to increase, we concentrated our efforts on identifying ways in which EO could enhance its enforcement and compliance efforts utilizing existing resources and personnel. However, as of the date of this report, it appears EO will be able to hire as many as 72 additional examination agents by the end of the 2004 fiscal year.[7] If this occurs, these new agents will enhance EO's compliance presence by increasing both the number and quality of the examinations that can be conducted. We strongly urge the IRS to follow through with its commitment to hire these additional EO examination agents by the end of the 2004 fiscal year, or sooner.

Whether these agents are added or not, it remains critical that EO management and staff continuously strive to create both the reality and perception of increased EO oversight in order to strengthen public confidence. There needs to be both the reality and perception that there is greater enforcement within the sector and that the likelihood of violators being caught and punished appropriately has increased. It was a recurring theme among EO practitioners interviewed for this project that EO needs to regularly make examples of exempt organizations and their principals who ignore the law.

These practitioners consistently commented about how frustrating it is for them to advise their clients to "do things the right way" and have so many respond that to follow the practitioners' advice would not only be more costly but, more importantly, that EO never seems to do anything to those who consistently fail to "do things the right way". These practitioners strongly recommended that EO aggressively pursue those organizations and individuals who ignore IRS requirements with apparent impunity so that their clients would take the practitioners' recommendations seriously. As will be seen from many of our recommendations, EO should be able to make significant strides to address these concerns by utilizing technological advances and other means to help EO examination personnel work more effectively and efficiently. However, given the explosive growth of the exempt sector over the last several decades, there is no getting around the fact that significant staff increases will also be required if EO is to do a truly credible job of overseeing this rapidly-expanding and vital sector of our economy.

IV. PROJECT PROCESS

In September 2003, we started our work on this project by interviewing several key individuals responsible for EO's current enforcement and compliance efforts. These individuals included: Rosie Johnson, Director, EO Examinations; Jo Ellen Dudycha, Central Mountain Area Manager; Mike Murphy, TEP Project Manager; Anita Sutherland, Manager, EO Classification; Dee Weise, Management Official; and Joanne Dorling, Mid-Atlantic Area Manager. We asked each to explain the current enforcement and compliance efforts for which he or she is responsible. Equally important, we asked each to assess the effectiveness of his or her current efforts and identify how they could

[7] Because EO has not been able to fill existing vacancies for some time now, its overall staffing levels will only increase by approximately 50 after these 72 positions are added.

be improved both within existing resource constraints and should additional resources become available. Based upon these interviews, we also reviewed appropriate statistical and other documentation to help determine the extent and effectiveness of EO's current enforcement and compliance efforts.

We also formally solicited input from both the American Bar Association's Tax Section Committee on Exempt Organizations (ABA Committee) and the National Association of State Charity Officials (NASCO) concerning EO's current enforcement and compliance efforts and how they could be improved. ACT member Karl Emerson wrote an article for *The Pennsylvania Nonprofit Report* describing this project and soliciting input from that publication's readership. Fred Stokeld of *Tax Analysts* also wrote an article about this project and encouraged readers to submit comments and suggestions. We also sought input from the American Institute of Certified Public Accountants (AICPA), the American Society of Association Executives (ASAE), the Council on Foundations, the Pennsylvania Bar Association's Charitable Organization Committee, and various state Attorneys General Offices.

In October 2003, we interviewed other EO personnel including: Steve Miller, Director, Exempt Organizations; Clint Siemens, Management & Program Analyst (Retired); Lois Lerner, Director, EO Rulings; Bobby Zarin, Director, EO Customer Education & Outreach; Midori Morgan-Gaide, Manager, Electronic Initiatives Office; and Donna Hockensmith, Management & Program Analyst. We also reviewed additional background documentation, including a complex chart that detailed the current EO case selection process.

On January 12 and 13, 2004, we interviewed Steven Pyrek, TE/GE Director of Communications and Liaison; Jennifer Whaley, Communication and Education Public Information Officer, who is in charge of publicity for the IRS Criminal Investigation Division; and Terry Lemons, IRS National Press Secretary, to discuss current efforts to publicize EO enforcement results and how they could be improved. We also interviewed Michael Julianelle, Director of the TE/GE Exam Redesign Project.

On January 30, 2004, ACT members Deirdre Dessingue, Karl Emerson, and Victoria Bjorklund participated in a presentation at the winter meeting of the ABA Committee and received input and suggestions for enhancing EO's enforcement and compliance efforts. Additional input was received from various members of the ABA Committee at its May 7, 2004 meeting in Washington, D.C.

Between January and April 2004, we interviewed various EO practitioners, a number of whom were former IRS officials, including: Ed Coleman, Alan Dye, Jay Rotz, Art Herold, Doug Mancino, Evelyn Brody, Marc Owens, and Celia Roady.

At our final working session in April 2004, we interviewed Paul Streckfus, Editor of *The EO Tax Journal*, to solicit his input about how EO's enforcement and compliance efforts could be enhanced. We were also briefed a second time by Michael Julianelle regarding the progress and findings of his extensive review of the entire TE/GE

examination process.

The informal input as well as any formal responses received from these individuals and organizations were all reviewed and incorporated, where appropriate, into this final report. We thank all who took time to give us their valuable input and suggestions.

V. EO's Current Examination Process

Currently, EO's examination program consists of the following:

General Compliance Examination Program. A general compliance examination involves a comprehensive review of an organization's management, activities and finances. This type of examination is usually conducted at the organization's offices. It may involve one or more agents and usually requires a considerable expenditure of both human and economic resources by EO and by the organization.

Large Case Program. The large case program generally involves full-scope, comprehensive audits of large exempt organizations, e.g., colleges, universities, and healthcare institutions. These audits likewise require a significant expenditure of human and economic resources on both sides.

Limited-Scope Examination Program. In its limited-scope examination program, EO identifies in advance one or more specific items on certain organizations' Form 990s and requests additional information only about those particular items. This may be accomplished through correspondence or by personal contact by an EO agent. Authorization is required to proceed beyond those issues.

Correspondence Exam Program. Correspondence examinations are desk audits in which the agent does not physically visit the exempt organization but, instead, simply requests certain documentation relevant to the particular, limited issues the agent is examining.

Market Segmentation Program. This is a relatively new initiative in which EO is examining various segments of the exempt sector to determine common areas of concern and noncompliance within each sector. EO takes statistically significant samples within each sector and then conducts comprehensive examinations of the selected organizations to determine the types of compliance issues unique to that particular sector. EO intends to publish the results of each market segment study to encourage other organizations within the sector to come into compliance voluntarily. These market segment examinations have been very labor and resource intensive and, to date, none have been completed.

Exempt Organizations Compliance Unit (EOCU). The EOCU is a new 15-person unit established in February 2004 and headquartered in Ogden, Utah. The EOCU primarily focuses on "soft contacts", ranging from educational initiatives to

correspondence exams, including follow-up on market segment cases. Case selection is directed from Dallas. The EOCU will work closely with the new Data Analysis Unit (DAU) that is scheduled to start up in the summer of 2004.

VI. Recommendations

After reviewing interview notes, documentation gathered, and comments and suggestions submitted by all interested parties, we offer the following recommendations to enhance EO's enforcement and compliance efforts with the ultimate goal of increasing public confidence and trust in the exempt sector.

EXAM-RELATED RECOMMENDATIONS: ***An essential element of any oversight agency's enforcement and compliance program is its ability to effectively select for more detailed review those organizations that are likely to be noncompliant or otherwise violating the law.***

1) EO Should Improve Its Case Selection Efforts And Develop An Ongoing Feedback Process For Continuous Refinement Of Its Selection Criteria.

EO's current case selection efforts yield an overall "no change"[8] rate of approximately 50%. Although a significant percentage of "no change" results is expected and desired for any state or federal oversight agency, EO's current 50% rate suggests that its case selection criteria need to be adjusted. Like any regulatory agency with limited resources, EO cannot be expected to catch all violators, but can always do a better job of selecting the cases it pursues. Key elements for improving EO's case selection should include the following:

Improved information gathering from all sources. EO's current procedures for selecting exempt organizations for examination can be improved by more effectively utilizing readily available sources of information such as media reports, more sophisticated analysis of Form 990 returns, and other means to more effectively select those cases where there is a higher likelihood of detecting material violations. The ACT wholeheartedly endorses the steps EO has recently taken to improve its case selection efforts by creating the new Exempt Organization Compliance Unit (EOCU) in February 2004 and Data Analysis Unit (DAU) that is scheduled to begin operations later this summer. In addition, since EO currently has the resources to enter only 25 percent of the Form 990 line items into the database used to select cases for examination, we likewise endorse EO's recent decision to acquire additional data from other sources.

The Form 990 is the key document used by both state and federal regulators to oversee and monitor the operations of exempt organizations. Like any form, it can be improved. EO has an experienced team working on a major revision of this document. To date, EO has received extensive written comments and suggestions to improve this

[8] "No change" means that no material violations were uncovered during the course of EO's audit or examination.

key form from the ABA Committee, AICPA, NASCO, and many other individuals and organizations. By incorporating many of the suggestions made by these individuals and organizations, EO will be able to improve the usefulness of the Form 990 as an enforcement and compliance tool. The EO members of the ACT have also provided, and will continue to provide, regular input and suggestions to this team, as well as to another team that has been working to revise the Form 1023 which EO uses in its initial evaluation of whether an organization is entitled to exempt status.

Because of the critical role the Form 990 plays in both federal and state oversight efforts, we recommend that EO establish a standing Form 990 review committee that would include representatives from NASCO. This standing committee should continuously evaluate the quality and utility of the information being submitted on Form 990 and revise the form appropriately. The committee should also take into account emerging trends and new compliance initiatives so that the Form 990 can serve as a more effective compliance tool.

Increased follow up on reports from the media and public. EO should focus more of its compliance efforts on reports in the media regarding potential violations in the exempt sector. One of the many functions to be performed by EO's new Data Analysis Unit (DAU) will be to search both national and local media sources daily for stories about alleged violations by exempt organizations, their officers, directors, or employees so that EO can promptly take appropriate follow-up action. While it is unrealistic to expect EO to uncover every case of exempt organization fraud and abuse, it is not unreasonable to expect EO regularly to uncover, document, and take appropriate action against those individuals and organizations that engage in the most egregious types of fraud and abuse --- especially in cases that receive widespread media coverage. At minimum, EO should routinely request written explanations from exempt organizations about which the media report serious allegations of wrongdoing. By promptly following up on all media stories alleging significant exempt organization abuses, EO should improve its case selection criteria and results.

In addition, EO should establish a dedicated "portal" to facilitate the reporting of potential violations by the public and the media. This "portal" should include a toll-free complaint line as well as the ability to file complaints through the EO website.

Improved ability to track performance measures and results. EO, like any regulatory agency, needs to improve its ability to track and measure the results of its examination efforts so it can determine whether these efforts have improved compliance within the sector. This feedback is essential for any regulatory agency to refine its case selection criteria on an ongoing basis. For example, the information gathered through EO's current market segment studies should be thoroughly analyzed as soon as possible after their completion to determine whether these resource-intensive projects have been worthwhile and should be continued. EO should continue its practice of having teams of experienced managers regularly evaluate the results of its examinations and lessons learned, particularly after the completion of any significant compliance initiatives. The results of these reviews should be shared regularly not just

within EO, but also with stakeholders and the exempt organization community at large. EO also needs to routinely evaluate its case quality and turnaround time to determine how they can be improved. EO's examination program is currently being thoroughly reviewed and evaluated as part of TE/GE's review of all its examination programs. Because the progress and preliminary findings of this review have been shared with the ACT on an ongoing basis and because the review is scheduled to be completed later this month, we have not included specific recommendations on these particular issues. All suggestions we received for improving the quality and turnaround time for EO examinations have been reviewed with Michael Julianelle, the IRS official in charge of conducting this comprehensive review of the entire TE/GE examination program.

2) EO Should Increase The Number Of "Limited Scope" Audits And Targeted "Soft Contacts" Within The Exempt Organization Community.

Given its resource constraints and the explosive growth of the exempt sector, EO will be able to comprehensively audit each year only a small percentage of the 1,640,949 exempt organizations. Therefore, to increase its presence within the sector, EO needs to increase the number of "limited scope" audits it performs as well as the number of targeted "soft" contacts it makes each year. This effort will increase the number of organizations "touched" and enhance both the reality and perception of increased enforcement.

In fact, EO has already begun to implement this recommendation with the creation of its new Exempt Organization Compliance Unit (EOCU) that specializes in developing innovative types of "soft" contacts that will henceforth be made routinely by EO. We commend this effort and encourage expansion of this initiative to target more effectively areas of potential noncompliance. For example, technology now enables EO to easily identify and contact organizations that report significant contributions but no fundraising expenses and request detailed written explanations of these apparent discrepancies.[9] Such targeted contacts can be accomplished with significantly fewer resources than are typically expended on a single comprehensive audit and "touch" thousands of organizations instead of just one. Similar types of "soft" contacts should be developed in order to show the exempt organization community and its advisors that EO does regularly examine Form 990s and follow up on apparent discrepancies and irregularities. By implementing this recommendation, EO will significantly enhance its "presence" in the exempt organization community. As soon as EO starts acquiring more comprehensive Form 990 data, it will be able to develop and implement many more of these cost-effective "soft" contacts.

[9] In fact, the newly-formed EOCU has recently undertaken this particular project based, in part, upon a *Chronicle of Philanthropy* article from several years ago that documented that as many as one quarter of all the organizations reporting contributions of over $500,000 may have falsely reported that they had no fundraising costs. See, "Charities' Zero-Sum Filing Game", *The Chronicle of Philanthropy*, Volume XII, Number 15, May 18, 2000.

PUBLICITY-RELATED RECOMMENDATIONS: ***An essential element of any oversight agency's enforcement and compliance program is its ability to effectively publicize the results of its enforcement efforts and the types of compliance issues about which it is concerned.***

3) <u>EO Should Improve Publicity Regarding Its Enforcement Efforts And Compliance Concerns.</u>

Historically, EO has not emphasized publicity as a compliance tool; however, this has begun to change. For example, last year front-page articles in *The New York Times*[10] and elsewhere detailed potential abuses among credit counseling agencies and EO efforts, along with state regulators and the FTC, to deal with abuses and to alert members of the public. In a particularly creative effort, a letter regarding abusive credit counseling agencies from Commissioner Everson was published in the *Dear Abby* column, reaching millions of readers who would otherwise have remained uninformed about these abuses. In another example, on April 16, 2004, *The Chronicle of Philanthropy* ran an article explaining how EO had "declared illegal a tax scheme under which charities and other tax-exempt groups helped companies avoid taxes through fraudulent charitable donations." This sort of positive publicity concerning EO enforcement efforts not only deters wrongdoing, but also serves to reassure the donating public that there is credible oversight by EO.

EO currently publishes its annual "work plan" or "implementing guidelines" which outline, for both EO examiners and the entire exempt organization community, those areas of compliance that will be of particular concern in the coming year. This publicity has been an excellent means by which EO has leveraged its resources. Issues identified in the "work plan" each year are widely discussed throughout the exempt organization community and among knowledgeable EO practitioners. Because most exempt organizations want to be in compliance and will generally conform their conduct and operations to do so, EO should continue to use this effective means of communication.

In addition to publicizing areas of compliance emphasis and concerns for the coming year, EO should begin reporting annually, on at least an aggregate basis, *the results* of its examination efforts and other compliance initiatives. For example, EO should widely publicize, on its website and otherwise, the "Top 10" types of violations it documented during the past year as well as the "Top 10" Form 990 errors it found. Areas of noncompliance highlighted in this annual report should also be used to develop a monthly compliance "tip" that would be posted on the EO web page. This "tip" feature should involve a short discussion of a particular compliance issue along with recommended corrective action. If this tip feature is widely publicized and posted on the same day every month, it could attract large numbers of viewers to the EO web page on a regular basis.

[10] See, "Not-For-Profit Credit Counselors Are Targets Of An IRS Inquiry", *The New York Times*, October 14, 2003.

4) EO Should Publicize Widely The Availability And Advantages Of Electronic Filing Of Form 990 And Encourage Exempt Organizations To Utilize This Option.

On February 23, 2004, EO debuted its long-awaited Form 990 electronic filing capability.[11] To date, 77 organizations have filed their Form 990s electronically and 54 have filed for extensions electronically. EO is to be commended for its willingness to expend the considerable resources that were required to make this innovative project a reality. This project will eventually enable EO to dramatically improve its oversight and monitoring of the exempt sector as well as enable both EO and the organizations that file electronically to realize significant cost savings. For example, as electronic filing of Form 990s becomes more popular, EO will be able to shift resources and personnel currently needed to manually process and store paper returns to substantive enforcement efforts. Electronic filing will also provide more accurate and timely data to both EO and the public. To date, the error rate for electronically filed Form 990s is only 7 percent whereas the error rate for manually filed returns is 53 percent. Further, electronic filing will enable EO to improve its substantive analysis and review of these returns so that it can more readily detect irregularities, inconsistencies, and omissions. Finally, electronic filing will eventually enable EO to improve its case selection criteria to more effectively select for examination organizations where there is a higher likelihood of noncompliance.

For all these reasons, EO should publicize widely the availability of electronic filing and continue to explore incentives to encourage organizations to file electronically. EO recently sent notification to over 500,000 exempt organizations and the IRS will also be sending notification to 66,000 tax professionals about the availability of this new electronic filing option. EO is also working closely with several key state regulatory offices, NASCO, and Independent Sector's Electronic Data Initiative Network (EDIN) to more widely publicize the availability of the new electronic filing option.

As soon as the more widely-used Form 990 preparation software is updated to incorporate electronic filing options, EO should consider making electronic filing mandatory for organizations with assets and/or annual revenue over a certain amount. Finally, as soon as EO implements electronic filing for Form 990 PFs[12], all private foundations should be required to file electronically.

[11] As of the date of this report, Form 990, Form 990-EZ, and Form 8868 (Extension of Time to File) can all be filed electronically.

[12] EO anticipates being able to accept electronically filed Form 990PFs early in 2005.

STAFF-RELATED RECOMMENDATIONS: ***An essential element of any oversight agency's enforcement and compliance program is its ability to recruit and retain sufficient numbers of well-trained, experienced staff to conduct its oversight responsibilities.***

5) <u>The IRS Should Follow Through With Its Commitment To Hire 72 Additional EO Examination Agents.</u>

Given the dramatic increase in the number of determination requests in recent years and EO's desire to provide good customer service by processing these requests in a more timely manner, it was understandable and appropriate for EO management to reassign many examination personnel to process determination requests. However, it is now critical that the EO examination vacancies created by this decision be filled and that additional positions be added. While it is true that many operational efficiencies can be realized as a result of technological advances, it is unrealistic to expect EO to effectively oversee approximately 90,000 additional exempt organizations each year with the same number of personnel. Over the years, members of many stakeholder groups, including Independent Sector, the Council on Foundations, the ABA Section of Taxation, and NASCO, have consistently urged that additional enforcement resources be provided to EO.

6) <u>EO Should Improve And Enhance Its Current Training And Education Programs For Agents And Examiners.</u>

It is imperative that training provided for EO agents and examiners keep pace with sector developments. Several practitioners related experiences in which they claimed EO agents were inadequately trained to conduct the particular audits to which they were assigned. As a result, these agents allegedly issued burdensome and irrelevant Information Document Requests (IDRs) that required the organizations in question to expend considerable resources complying with these overly-broad and unnecessary requests for information. As with any organization, experienced agents leave or retire on a regular basis and it is critical that EO maintain an ongoing comprehensive education program for its agents and examiners so that they have the appropriate training and skills to conduct their assignments. As a result of budget constraints, EO's ability to offer traditional training opportunities in which agents travel to central locations to receive face-to-face training conducted by EO subject-matter experts has been severely curtailed. In its place, EO has offered on-line training courses and more video conference training. EO should evaluate whether this on-line and video conference training is as effective as face-to-face training and should consider reinstituting at least some face-to-face training by EO subject-matter experts as soon as budgetary constraints allow.

PUBLIC EDUCATION RECOMMENDATIONS: ***An essential element of any oversight agency's enforcement and compliance program is its ability to regularly***

educate the organizations it oversees so that the organizations can ensure they are in compliance with all applicable laws, rules, and regulations.

7) <u>EO Should Increase Its Issuance Of Technical And Precedential Guidance</u>.

EO practitioners interviewed expressed considerable frustration regarding the significant decrease in the level of technical[13] and precedential EO guidance issued in recent years. They contend that this seriously hinders their ability to properly advise their exempt clients. It is indisputable that the amount of published guidance issued by EO has decreased significantly in recent years for a variety of reasons. The availability of technical and precedential guidance can greatly increase overall compliance when organizations and their advisors know how EO views certain transactions and practices. EO is to be commended for recently publishing Revenue Rulings 2002-28, 2003-13, and 2004-51 that have each received widespread, and favorable, coverage within the exempt organization community.

Therefore, EO should regularly issue relevant technical and precedential guidance for the exempt organization community and its advisors. Because most organizations will readily conform their conduct to comply with published guidance that clarifies "gray areas" of the law, EO should take full advantage of this cost-effective way to leverage its compliance efforts.

We commend EO for recently posting to the EO web page all past Continuing Professional Education (CPE) Manuals so that this technical guidance is readily available to exempt organizations and their advisors. However, EO needs to follow through with its announced plans to regularly post additional relevant CPE articles on its web page in a more timely manner.

8) <u>EO Should Increase The Number And Technical Content Of Public Presentations And Other Educational Initiatives.</u>

EO leadership and technical staff need to take full advantage of any and all opportunities to interact with and educate members of the exempt organization community and their legal and accounting advisors. Public interaction and speeches by EO leadership and technical staff are, and have historically been, an important way for EO to leverage its limited resources by providing information about EO technical positions, various enforcement and compliance efforts, and areas of concern. By speaking regularly about EO's technical positions, enforcement efforts, and compliance concerns at national and regional conferences for exempt organizations and their legal and accounting advisors, EO leadership and technical staff help educate the exempt organization community about irregularities and violations EO agents are uncovering

[13] Technical guidance refers to non-precedential information concerning EO's views on particular transactions or practices. Such guidance includes private letter rulings, technical advice memoranda, and continuing professional education texts.

during their examinations. When EO leadership and technical staff highlight these areas of concern, EO practitioners routinely advise their exempt organization clients to make sure their organizations are in compliance in those areas. For example, if EO leadership or technical staff indicate at a major national conference that EO either is, or will soon be, taking a look to see whether organizations are correctly reporting "gross contributions" rather than just "net contributions" on Line 1a of their Form 990 returns, most exempt organization representatives will ensure that their organizations are properly completing this line on the Form 990. Thus, as a result of a single comment made by EO leadership or technical staff at a conference, dozens, if not hundreds, of organizations may remedy a significant discrepancy on their Form 990s without a single letter or formal contact having been made by EO. EO needs to take full advantage of this simple, cost-effective way to leverage its resources.

CONSEQUENCE-RELATED RECOMMENDATION: ***An essential element of any oversight agency's enforcement and compliance program is its ability to encourage compliance by regularly documenting and pursuing significant violations of the laws, rules, and regulations the agency is responsible for enforcing.***

9) <u>EO Should Increase The Consequences For Both Individuals And Organizations That Intentionally Submit False Form 990 Returns Or Otherwise Violate The Law.</u>

EO should enhance its review of Form 990 returns so that, at minimum, organizations that file returns containing apparent falsifications, misrepresentations, and/or omissions are routinely required to explain these apparent discrepancies and, if appropriate, file amended Form 990s. As was mentioned earlier, technological advances will enable EO to conduct more substantive review of Form 990s to detect, and follow up on, apparent falsifications, misrepresentations, and/or omissions on these key public documents. As it acquires more comprehensive Form 990 data, EO will enhance its abilities in this area and thereby improve the accuracy of these key documents upon which the donating public, the media, and regulatory oversight agencies must necessarily rely. As was pointed out at the beginning of this report, it is crucial that exempt organizations, their advisors, and the public feel confident that EO routinely reviews Form 990s and follows up on apparent discrepancies.

EO should ensure that individuals and organizations that intentionally file false Form 990s and Form 1023s are prosecuted appropriately. EO needs to ensure that both individuals and organizations that intentionally submit false Form 990 returns and Form 1023 applications are prosecuted appropriately under Sections 7206(1) and (2) of the Internal Revenue Code. Section 7206(1) authorizes the prosecution of any person who willfully makes a false statement in a return or other document submitted to the IRS. Section 7206(2) authorizes the prosecution of any person who "willfully aids or assists in . . . counsels, or advises the preparation . . . of a return . . . which is fraudulent or . . . false as to any material matter." Since both Form 990s and Form 1023s are

signed under penalty of perjury, those who make intentional material false statements in Form 990s and Form 1023s should be prosecuted for doing so. This will send a clear message to those who prepare and submit these public documents upon which EO, state regulators, and the public must necessarily rely, that those who intentionally falsify these documents will be prosecuted appropriately. To facilitate EO's ability in this regard, it should create a specialized fraud unit, staffed with experienced EO agents and attorneys who have demonstrated their ability to assemble and document complex fraud cases. Implementation of this recommendation will improve the quality and integrity of the Form 990s filed with EO and is especially important given the fact that almost two million Form 990s are now widely available on the Internet through the *GuideStar* website.[14] To the extent that many of these Form 990s contain material falsifications, misrepresentations, and omissions, their value is significantly diminished.

EO should increase criminal referrals when egregious and illegal conduct by exempt organizations and/or their principals is documented. While it is true that much of the wrongdoing by exempt organizations and their officers, directors, and employees does not rise to the criminal level, some of it unequivocally does. Therefore, it is critical that documented allegations of egregious and illegal conduct by exempt organizations and/or their principals be pursued criminally in order to deter others and to increase public confidence in the sector. To maximize the deterrent effect of these cases, all criminal prosecutions of exempt organizations and/or their principals should be highly publicized by EO.

ENFORCEMENT-RELATED RECOMMENDATIONS: ***An essential element of any oversight agency's enforcement and compliance program is its ability to encourage voluntary compliance and to coordinate its efforts with state and federal agencies that have similar enforcement responsibilities.***

10) <u>EO Should Implement A Formal Voluntary Compliance Program.</u>

There is considerable anecdotal evidence that many exempt organizations are not in compliance either because they have not filed required Form 990 returns or otherwise. Many of these organizations remain out of compliance mainly because of their concern that if they voluntarily call attention to their noncompliance they will be subjected to prohibitively high fines, penalties, and interest that would literally put them out of business. Knowledgeable EO practitioners have known for years that EO has an "informal" voluntary compliance program where organizations that have been out of compliance for many years can often get back into compliance after agreeing to pay negotiated penalties and interest for only the most recent of their years of noncompliance. However, the existence of this "informal" EO voluntary compliance program is not widely known within the exempt organization community. Given the success of TE/GE's other voluntary compliance programs, EO should consider

[14] As of March 1, 2004, *GuideStar* had approximately 1.7 million IRS 990s available on its website at www.guidestar.org .

implementing its own formal voluntary compliance program so that many more organizations can be given the opportunity to remedy their noncompliance without fear of being subjected to prohibitively high fines, penalties, and interest. Given EO's limited resources, many of these organizations might otherwise never be discovered and brought into compliance.

11) <u>EO Should Vigorously Support Amendment Of Section 6103.</u>

As was noted at the outset of this report, while EO plays a vital role in overseeing and monitoring the exempt sector, it is not the only governmental entity charged with this responsibility. EO shares this responsibility with various state regulatory offices that are also charged with overseeing and monitoring exempt organizations operating in their respective states. However, Section 6103 of the Internal Revenue Code does not permit EO to share information or coordinate its enforcement efforts with these various state regulatory agencies.

Donors, legitimate exempt organizations, the media, and Congress all expect state regulators and EO to pursue aggressively those who defraud donors and siphon millions from the exempt sector each year. Unfortunately, Section 6103 of the Internal Revenue Code significantly hinders EO's and state regulators' abilities to fulfill this expectation because it prohibits EO from sharing information and coordinating its investigations and audits with the various state agencies that have concurrent responsibility to oversee the exempt sector. This prohibition even prevents EO from sharing information with state regulators on cases the states have developed and referred to EO. Consequently, amendment of Section 6103 would significantly increase the effectiveness of both EO and state regulators by allowing them to coordinate their investigative and audit activities where appropriate.

Amendment of Section 6103 has been the number one strategic planning goal of NASCO for many years. Section 6103's amendment has been recommended by both the staff of the Joint Committee on Taxation[15] and the General Accounting Office,[16] and has been incorporated into one of the most recent versions of the CARE Act. As recently as March 21, 2004, U.S. Senate Finance Committee Chairman Charles Grassley reaffirmed his support for amending Section 6103 and indicated his intention to do whatever it takes to get this beneficial amendment passed.[17] For all these reasons, EO needs to vigorously support the proposed amendment of Section 6103.

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[15] See, "Volume II: Study of Disclosure Provisions Relating to Tax-Exempt Organizations", Joint Committee on Taxation Staff Report, January 28, 2000, JCS-1-00

[16] "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities", GAO Report to the Chairman and Ranking Minority Member, Committee on Finance, U.S. Senate, GAO-02-526.

[17] See "Questions About Some Charities' Activities Lead To A Push For Tighter Regulation", *The New York Times*, March 21, 2004, where it states that "[i]f Mr. Grassley has his way, federal and state regulators may begin working together more closely to oversee charities. He is trying to find ways to better coordinate the activities of the

VII. CONCLUSION

EO and state regulators serve vital roles in maintaining confidence in the exempt sector by exercising their respective oversight and monitoring responsibilities. EO plays a particularly crucial role since it is the government entity responsible for determining which organizations receive, and retain, exempt status. In this capacity, EO helps assure the donating public that organizations granted exempt status are legitimate and worthy of support. Contributors, exempt organizations, and their professional advisors need to feel confident that EO thoroughly reviews applications for exempt status; routinely reviews exempt organization annual Form 990 returns; investigates questionable returns and organizations; and ensures that those who intentionally falsify these returns or otherwise violate the law are punished appropriately.

By implementing the recommendations outlined in this report, EO will enhance its enforcement and compliance efforts and significantly increase its "presence" in the exempt organization community, even in an environment of fiscal austerity. Implementation of each recommendation will result in a "ripple" effect throughout the exempt organization community as EO's enhanced enforcement and compliance efforts become more widely known. The reality and perception that EO is more effectively overseeing the sector will function like a single stone tossed into the water increasing awareness throughout the exempt organization community.

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attorneys general and the Internal Revenue Service, which oversees tax-exempt organizations at the federal level. Measures that would let the IRS share more information with state regulators are included in pending legislation. "If they don't get through there, we'll have other tax bills and we'll incorporate them in those," the senator said."