ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

PROPOSAL FOR AN EXEMPT ORGANIZATIONS VOLUNTARY COMPLIANCE PROGRAM

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

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

--National Taxpayer Advocate Nina Olson, September 2006[1]

Executive Summary

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

1. The Case for an Exempt Organizations Voluntary Compliance Program

A. The Problem

[1] Written Statement of Nina Olson, National Taxpayer Advocate, Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Government Affairs, Committee on Finance, United States Senate, *Hearing on the Tax Gap*, September 26, 2006, www.irs.gov/pub/irs-utl/ntatestimonysfctax_gap072606.pdf.

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

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

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

[3] *National Taxpayer Advocate, 2005 Annual Report To Congress,* Taxpayer Advocate Service, December 31, 2005, p. 293, http://www.irs.gov/pub/irs-utl/section_1.pdf.

[4] References to the "IRS" or the "Service" refer to the Internal Revenue Service.

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

EO[6] Examinations office, but it may be a person without any subject-matter nexus or other connection to the problem. Here are some examples of non-compliance issues described to us by lawyers and accountants practicing in this area:

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

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

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

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

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

B. A Voluntary Compliance Program for Exempt Organizations

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

[7] Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat 780.

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

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

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

noncompliance is extensive, noting that in approximately 24% of the cases examined in one study of the problem, the person responsible for maintaining the organization's books and records was unaware of the obligation to file an annual information return.[11]

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

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

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

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[11] Exempt Organizations Nonfiler Study Report of Findings, December 1994.

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

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

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

2. The Process

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

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

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

of Certified Public Accountants. What follows are some highlights of the survey responses.[13]

A. The Range and Frequency of Noncompliance Issues

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

B. Experience with the IRS When Addressing Noncompliance Issues

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

C. Opinions on Different Aspects of a Voluntary Compliance Program

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

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

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

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

3. The Context

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

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

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

A. Voluntary Compliance Initiatives in the Employee Plans Division

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[17] *Improvements for More Effective Tax-Exempt Bond Oversight*, GAO Tax Policy and Administration, GAO/GGD-93-104, May 10, 1993.

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

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

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

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

C. <u>Voluntary Compliance Initiatives in the Indian Tribal Government Division</u>

[18] *IRS Data Book 2006*, Internal Revenue Service; Publication 55B (Washington DC, March 2007).

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

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

D. Voluntary Compliance Initiatives in the Exempt Organization Division

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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[24] I.R.M. 4.75.25.13.

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

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

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

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

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

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

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

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

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

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

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

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

[27] *See* G.C.M. 39862 (Nov. 21, 1991).

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

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

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

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

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

E. What We Learned

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

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

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

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

4. Framework for an EO VCP

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

A. Designing an EO VCP

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

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

- **Take into account the lessons learned** from successful and unsuccessful VCPs in other areas of TE/GE, but note the differences as well. For example, EO returns are public while these others are mostly not; EOs often are represented by volunteers while others almost always have professional assistance, and EOs are most often small organizations while others are often larger.

- **Understand the incentives** and disincentives for participation in a VCP that would operate in an EO program (including the contrasting impetus provided by third party interests in other VCPs and the depressing effect caused by limited IRS enforcement resources), and build in positive and negative inducements wherever possible.

- **Be mindful of audit and enforcement priorities** in EO, and address issues, define eligibility, and design a process that will provide a less costly mechanism to resolve problems but will not undermine those priorities (by, for example, requiring an extension of the statute of limitations as a condition for participation).

- In order to conserve resources efficiently and measure success effectively, **start with a relatively straightforward program** with predictable outcomes and fewer exercises in reviewer discretion, expanding to more complex and fact-specific issues later.

- If not already measured, **create a baseline of information** about noncompliance on the issue that is the subject of the VCP, and track both participation rates and outcomes at regular intervals once the VCP is under way.

- **Commit significant resources over a sustained period to marketing** such a program to the EO community in general and to the targeted population in particular.

B. <u>Operating an EO VCP</u>

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

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

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

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

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

5. Recommendation: A Voluntary Compliance Program For Exempt Organizations

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

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

A. Transitional VCP

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

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

- **Eligibility:** Every exempt organization that is obligated, under IRC 6033, to file a return or a notice and that is not under examination, in Appeals, or in court on a tax matter involving a year for which the organization proposes to file a return or notice, is eligible to participate in this VCP.

- **Filing obligation:** Form 990, 990-EZ, 990-PF, or 990-T, as applicable, for the three most recent tax years, together with Forms 941, 1099, and W-2, if

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

applicable, for any period during the three most recent tax years for which such returns were otherwise due.[29]

- **Payment:** The organization must pay all taxes due with the return or notice, with applicable interest. For example, if the organization files a 990-T to report income from an unrelated business activity, it must pay all tax due on that income along with all interest due the Service on the unpaid tax. Similarly, if the organization had employees but failed to timely file Form W-2 and remit applicable payroll taxes, it must remit those taxes together with applicable interest.

- **Penalties:** No penalties would be assessed for filing delinquencies, although no relief would be provided for any other issues, including any problems reflected in the delinquent returns filed to participate in the program. For this limited time, the IRS would not assess the late filing penalties that it would otherwise be entitled to assess for failure to timely file the returns covered by this VCP.[30] We make this recommendation because we believe that the Service and the public derive a greater benefit from access to the information reported on these returns and notices and (importantly) from bringing these non-filers back into long-term compliance, going forward, than they would gain from assessing late filing penalties.

- **User fee:** A sliding scale would apply, with no fee for participating organizations with assets and revenues under $1 million in each of the three years for which delinquent returns are filed. We make this recommendation because we believe it is in the best interests of the Service and the public to avoid disincentives for small organizations to participate in this transitional VCP.

- **Time frame:** We strongly recommend commencing the transitional phase of this program as soon as possible, with an end date of December 31, 2010. The Pension Protection Act provides that automatic revocation will be imposed for a failure to file three consecutive returns for any reporting period beginning after 2006. Therefore, automatic revocations for organizations now "outside the system" will begin on January 1, 2010 and be completed on December 31, 2010 (although automatic revocations will continue thereafter for exempt organizations that subsequently fail to file for three consecutive years). This means it is essential to begin *now* to implement this transitional VCP.

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

[30] IRM Section 20.1.1.3.2.2, Administrative Waiver (8/20/1998).

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

B. Ongoing VCP

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

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

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

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

- the organization's failure to file the return(s) was due to reasonable cause;[31]

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

- the exempt organization is not under examination by the IRS, in Appeals or in court with respect to any issue within the jurisdiction of the IRS.

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

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

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

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

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

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

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

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

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

a. file any delinquent Forms 990/990-EZ/990-PF and Form 990-T for the prior three years, and correct any forms W2 or 1099 for which relief is sought;

b. simultaneously file any ancillary returns due, such as Form 4720 for payment of the Section 4911 tax on excess lobbying expenditures by public charities that have elected to be subject to Section 501(h), Form 1120-POL in the case of an exempt organization treated as having political organization taxable income under Section 527(f)(1), or Form 926 in the case of transfers of property to a foreign corporation;

c. include payment for any taxes shown as due on those returns (e.g., Section 4940 tax on investment income, unrelated trade or business taxes); and

d. agree to maintain books and records going forward sufficient to allow it to continue to file its forms on a current basis.

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

a. name, address, telephone number, fax number, and employer identification number;

b. contact person (at organization or an authorized representative, and in the latter case Form 2848, Power of Attorney must be submitted with the Statement), with name, address, telephone number and fax number;

c. the unfiled return(s) with all taxes shown as due;

d. how it was discovered that the return(s) should have been filed but was(were) not and why that constitutes reasonable cause;

e. representations under penalties of perjury that the exempt organization is not under examination by the IRS, in Appeals or in court with respect to any issue relating to the jurisdiction of the IRS, the delinquent return(s) filed with the Statement is(are) complete and accurate and the exempt organization agrees to maintain books and records going forward sufficient to allow it to continue to file its form(s) on a current basis;

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

f. in the case of delinquent Forms 990-T and 990-PF, the exempt organization would agree to waive all defenses to the assessment and collection of penalties for failure to file estimated taxes;

g. in the case of late tax payments, the exempt organization would agree to waive all defenses to the assessment and collection of statutory interest;

h. the Statement would make clear that if the delinquent return(s) is(are) not complete and accurate, the exempt organization may be subject to IRS audits and penalties that could cover more than the three years potentially at issue; and

i. where appropriate, the Statement would include a waiver of the statute of limitations by the exempt organization.

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

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

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

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

[34] Our approach to user fees for participation in the proposed ongoing VCP is intentionally different from our proposed transitional VCP.

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

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

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

APPENDIX 1: Persons Interviewed for This Report

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

Robert Choi, Director, EO Rulings and Agreements

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

Marvin Friedlander, Manager / Technical, EO Rulings and Agreements

Clifford Gannett, Director, Tax-Exempt Bonds

Joseph H. Grant, Director, Employee Plans

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

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

Lois Lerner, Director, Exempt Organizations

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

Peter Lorenzetti, Area Manager Northeast, EO Examinations

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

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

Steven T. Miller, Commissioner, TE/GE

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

Marsha Ramirez, Director, EO Examinations

Lisa Schultz, Senior EO Mandatory Reviewer (EO Examinations)

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

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APPENDIX 3: Comparison of TE-GE Voluntary Compliance Programs

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