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Regulation of the Voluntary Sector in the New Millennium

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In the waning years of the Twentieth Century, the United States Congress authorized a comprehensive review of the nation's tax administration system by creating The National Commission on Restructuring the Internal Revenue Service¹ ("National Commission"). The Internal Revenue Service's ("IRS") oversight of the voluntary sector was included within the scope of this review, and the report issued by the National Commission included several recommendations on improving tax administration in this vitally important area of our society.² Although these recommendations were subsequently deleted from proposed legislation to implement the National Commission's recommendations, they formed the basis for potential significant changes to the IRS's oversight program for exempt organizations proposed by IRS Commissioner Charles Rossotti. This article will discuss the proposed regulation of the voluntary sector in the new millennium.

Historic Basis of Governmental Oversight of the Voluntary Sector

¹ Pub. L. No. 104-52, 109 Stat. 509, (Nov. 19, 1995), as amended by Pub. L. No. 104-134, 110 Stat. 1321, §2904 (April 26, 1996) and by Pub. L. No. 104-208, 110 Stat. 3009, §643 (Sept. 30, 1996).

² *Vision for a New IRS*, Report of the National Commission on Restructuring the Internal Revenue Service (June 25, 1997), P. 38.

The concept of tax exemption is firmly rooted in the history of the federal income tax law. In the late 1800's, the nation was locked in an intense debate over its system of taxation and whether to implement a flat tax. At that time most of the nation's revenue needs were met through customs and special excise taxes such as the one on distilled spirits, which had already caused the Whiskey Rebellion of 1794. That source of revenue was deemed insufficient to finance the needs of the nation as it moved into a new century. Accordingly, the Tariff of 1894 imposed a flat two percent tax on individual and net corporate income. For the first time, Congress grappled with the task of determining whether there would be exemptions from this flat tax. In section 32 of the Tariff of 1894, Congress provided for the exemption of "corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes."³ The flat tax method of taxation almost immediately succumbed to constitutional challenge.⁴ Although the first "income tax" failed, the Sixteenth Amendment was ratified in 1913, and the Tariff of 1913 imposed a progressive tax on individuals. As the United States was drawn into World War I, sharply increasing the need for revenue, tax rates increased correspondingly and the principle of progressive income taxation became firmly established. The principle of tax exemption also became firmly established: an exemption for "charitable, religious, or educational" organizations has been included in every revenue act since 1894.⁵

³ Tariff of 1894, ch. 119, §349, §27-33, 28 Stat. 509, 553-57.

⁴ Pollock v. Farmers' Loan and Trust Company, 157 U.S. 429 (1895).

⁵ McGovern, "The Exemption Provisions of Subchapter F," 29 *Tax Lawyer* 523 (1976).

Regulation of the "Voluntary Sector" -- the Early Days

Throughout the first three quarters of the twentieth century, exempt organizations were regulated as part of IRS's overall tax compliance program. During that period, the IRS was organized along functional lines. Audits were conducted by IRS agents who specialized in exempt organizations matters. These agents reported to a district director, who in turn reported to a regional commissioner. Technical guidance, if needed was provided by a section of the Office of the Assistant Commissioner (Technical) in Washington, D.C. that specialized in exempt organizations matters. Generally, exempt organizations oversight was not a high priority as it constituted a small fraction of the overall tax compliance program, and was a non-revenue producing activity. One study found that IRS exempt organizations officials were "somewhat handicapped" by cumbersome procedures that were designed generally to meet the needs of the tax-collecting branches of the IRS; inadequate authority in relation to other officials near the top of the IRS's hierarchy; the understandable emphasis of the IRS on its role as tax collector rather than as overseer of a non-revenue-producing activity; and the generally weaker qualifications and training of the IRS's field staff as compared with the National Office staff.⁶

Significant changes to the law of tax-exempt organizations in 1969 caused Congress to provide specialized funding for exempt organizations oversight. In the Tax Reform Act

⁶ *Giving in America - Towards a Stronger Voluntary Sector* (1975); *Research Papers, Vol. 5*. "Federal Oversight of Private Philanthropy, p. 2583.

of 1969 Congress reacted strikingly to a number of well-published abuses of tax laws by private foundations by enacting over twenty pages of restrictive Code material.⁷ Section 509 was added to the Internal Revenue Code to divide section 501(c)(3) organizations into two groups, public charities and private foundations. The latter became subject to a series of comprehensive, complex excise taxes.

Congress recognized that the IRS would need to strengthen its commitment to oversee exempt organizations in light of the new regulatory regime for private foundations. As such, it enacted an annual four percent excise tax (sometimes referred to as an “audit fee”) on the net investment income private foundations:

The Congress has concluded that private foundations should share some of the burden of paying the cost of government, especially for more extensive and vigorous enforcement of the tax laws related to exempt organizations.⁸

The Employee Retirement Income Security Act of 1974

On Labor Day, September 2, 1974, President Ford signed into law the Employee Retirement Income Security Act, popularly called ERISA. Although the legislation was intended primarily to commit the resources of the federal government to protect the

⁷ IRC §§507-509 and §§4940-48.

⁸ Joint Committee on Internal Revenue Taxation, *General Explanation of Tax Reform Act of 1969*, 91st Cong., 2d Sess. (1970), at 29.

retirement benefits of the American workforce, it revised the IRS's tax administrative structure to provide for both pension plans ("employee plans") and exempt organizations.

An unusual feature of ERISA was an unprecedented amendment to the Internal Revenue Code found in section 7802(b). This section specifically established within the IRS an office of employee plans and exempt organizations ("EP/EO") and provided that it would be headed by an assistant commissioner. The explicit congressional purpose of section 7802(b) was to ensure that the non-revenue raising nature of the Service's employee plans and exempt organizations activities would receive high-level attention and priority in an agency otherwise primarily responsible for tax collection functions.⁹ As the legislative history of section 7802(b) states:

Concern has been expressed in the case of the administration of employee benefit plans (and also tax-exempt organizations) as to whether the Internal Revenue Service with its primary concern with the collection of revenues is giving sufficient consideration to the purposes for which these organizations are exempt. Many believe that the present organization of the Service causes it to subordinate concern for the protection of the interests of plan participants (or the educational, charitable, etc., purposes for which the exemptions are provided).

⁹ S. Rep. No. 383, 93rd Cong., 2d Sess. 107-8 (1974). 1974-3 C.B. 186-7.

...[I]t must be recognized that the natural tendency is for the Service to emphasize those areas that produce revenue rather than those areas primarily concerned with maintaining the integrity and carrying out the purposes of the exemption provisions. Similar concern has been expressed in the past over the Service's administration of the provisions of the tax law relating to exempt organizations.

Your committee believes that in the employee benefit plan and tax-exempt organization area it should be easier to emphasize the basic objectives involved if the activities relating to these plans and exempt areas relating to auditing, rulings, etc. whether in the field or in the national office are brought together and if the top direction for these activities also has specialized in them. For the reasons outlined, the bill establishes a separate office in the Internal Revenue Service, headed by an Assistant Commissioner for Employee Plans and Exempt Organizations to deal primarily with plans that are (or claim to be) qualified under section 401 of the Code and organizations that are (or claim to be) exempt from income taxes under section 501(a) of the Code.¹⁰

Congress recognized that the responsibilities of this new office would require a substantial increase in staffing. Accordingly, in section 7802(b)(2), it authorized an annual appropriation equal to one-half of the section 4940 excise tax on net investment income tax of private foundations (then a four percent rate) plus the greater of the same

¹⁰ Id.

amount or \$30 million. Legislative history reflects that funding for twenty "supergrade" positions (today's Senior Executive Service position) was to be included in the appropriation. Both the House and Senate Reports indicate that the responsibilities and functions of EP/EO were to be funded by this dedicated appropriation.¹¹ The Senate Report also indicated that the funds provided "are to be used only for activities delegated to this new office and may not be transferred or used by the Internal Revenue Service in any other manner."¹²

Despite this specific legislative intent, the amounts raised by the section 4940 excise tax were never earmarked for the administration of EP/EO. Rather, they went into the general revenues. Accordingly, the amount of funds available to EP/EO has always been dependent on annual Treasury appropriations.¹³ Accordingly, many of the progressive oversight structures envisioned for EP/EO never materialized. For example, after the enactment of ERISA, the IRS created the position of Assistant Regional Commissioner (EP/EO) in each of the then seven regions. This structure was designed, pursuant to EP/EO's legislative history, to enable the Assistant Commissioner to establish a uniform national policy by interacting with supergrade (Senior Executive Service) positions in the regions who were directly responsible for EP/EO matters. However, the Assistant Regional Commissioner (EP/EO) position was abolished in a 1978 reorganization, and the responsibility was assumed by a senior executive responsible for the Service's general

¹¹ H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 105 (1974); S. Rep. 93-383, 93d Cong., 1st Sess. 109 (1973).

¹² S. Rep. 93-383, 93d Cong., 1st Sess. 110 (1973).

¹³ Staff of the Joint Comm. on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, H.R. 4170, 98th Cong., 672 (1984).

examination program. Of the 20 supergrade positions envisioned for EP/EO in 1974, four exist today: Assistant Commissioner (EP/EO); Special Assistant to the Assistant Commissioner; Director, Employee Plans Division; and Director, Exempt Organizations Division.¹⁴

The Employee Retirement Income Security Act was, as its name suggests, primarily directed to insuring the pension security of the nation's citizens. Outside of the references to tax-exempt organizations in the above cited Committee Reports, it is not evident why exempt organizations were included with pension plans in the new EP/EO organization. Donald C. Alexander, IRS Commissioner at the time ERISA was enacted, provides a fascinating, first-hand explanation. According to Mr. Alexander, he and the late Dr. Laurence Woodworth, Chief of Staff of the then Joint Committee on Internal Revenue Taxation, had lunch on most Saturdays where they frequently talked about ERISA, reviewing substantive matters, drafting issues, legislative strategy, jurisdiction, and procedural matters. Combining the exempt organizations function with the pension function was apparently the subject of discussion at those luncheons.

Why combine EP with EO? Larry Woodworth and I thought that exempt organizations should be linked to employee plans. Both deal with powerful tax incentives (tax deductions for charitable contributions and compensation, tax

¹⁴ McGovern, "A Look in the Rearview Mirror: What Does It Tell Us About the Road Ahead?", 13 *EOTR* 937, 938 (1996). See also, Alexander, "ERISA 1974-1994 Twenty Years of Pension Reform -- and Beyond (Part 13)," 66 *Tax Notes* 1167 (1995)

exemption for charitable entities and qualified plans, and tax benefits for qualified participants in qualified plans). Both required the Internal Revenue Service to abandon its tax-collector and revenue-enforcer philosophy and instead be the reasonable and thoughtful, even-handed and fair regulator that encourages the creation and operation of organizations that perform a public good and encourages the creation and maintenance of retirement plans that perform a public service.¹⁵

It is important to note that while exempt organizations may have been an afterthought to Congress's major revision to the pension tax law, Congress decided to use tax revenue generated from the *exempt sector's* section 4940 net investment income tax to fund the IRS's new EP/EO organization, *i.e.*, the exempt sector would fund IRS's oversight program for *both* employee plans and exempt organizations.

Regulation of the Voluntary Sector -- Post ERISA

The new EP/EO organization was comprised of a National Office headquarters and seven (now five) key district offices. Headquarters is staffed principally with lawyers, actuaries, and support staff who deal with the most sensitive and complex cases, and who, under the direction of the Assistance Commissioner (EP/EO), issue national program guidance, audit guidelines, technical guidance, private letter rulings, pension funding

¹⁵ Alexander, N 14, *supra*.

waivers, and who administer the EP/EO's unique and distinctive voluntary compliance programs.

EP/EO's field function operates an enforcement program that is divided into two categories: determinations (exemption applications) and examinations (audits). It is staffed principally by Internal Revenue Agents and support staff who are overseen by a senior manager in each key district office. These managers report to key district directors who, in turn, report to a regional commissioner. Under this structure, the Assistant Commissioner has general programmatic and budgetary authority, but no direct line authority over the audit function.

The mission statement for the new EP/EO office was drafted to differ from that of the tax collection mission of the IRS to reflect the regulatory role that Congress envisioned for EP/EO:

Internal Revenue Service Mission:

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Employee Plans and Exempt Organizations Mission:

Our Mission is to fairly and impartially administer the federal tax laws pertaining to employee plans and tax exempt organizations in a manner that reflects the highest degree of integrity. We are committed to providing our customers with the highest quality service possible in a timely, efficient and courteous manner.

Growth of the Exempt Sector

While Congress recognized the importance of EP/EO in the early 1970s, it could not have foreseen the subsequent dramatic increase in the size, sophistication, and importance of this sector of the economy. In the pension area today, 77 million workers - more than double that of 1974 - participate in 900,000 retirement plans with assets of \$1.7 trillion.¹⁶ Pension plans account for the largest single tax expenditure in the federal budget -- estimated to be \$83.5 billion in 1997.¹⁷

Similarly, the number of tax-exempt organizations has almost doubled - from 690,000 to 1.1 million. Assets now exceed \$1.2 trillion. Total annual revenue is \$743 billion, representing 11 percent of Gross Domestic Product. This data does not include the nation's estimated 340,000 churches.¹⁸ The tax expenditure related to contributions, gifts, grants, and bequests received by exempt organizations (*i.e.*, the foregone Treasury

¹⁶ "ERISA - A 20 YEAR RETROSPECTIVE," IR-95-14, January 30, 1995 (speech of Commissioner Margaret Milner Richardson before the American Bar Association Tax Section).

¹⁷ Staff of the Joint Comm. on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 1997-2001*. JCS-11-96 (November 26, 1996).

¹⁸ "ERISA - A 20 YEAR RETROSPECTIVE," N5, *supra*.

revenue) is estimated to be \$21 billion in 1997.¹⁹ This figure does not include the cost of overall corporate income tax exemption for such organizations.

In June, 1993, shortly after the General Accounting Office issued a sharply critical report of the IRS's oversight of the tax-exempt bond sector, EP/EO assumed responsibility for the Service's tax-exempt bond compliance program at a time when the total volume of outstanding tax-exempt debt was approximately \$1.2 trillion. The tax expenditure related to tax-exempt bonds is estimated to be \$22 billion for 1997.²⁰ Although this was an appropriate response from the IRS to deal with a serious tax administration problem, it expanded the congressional mandate for EP/EO and was not supported with additional IRS funding. Moreover, because EP/EO made a determination that the bond program would be the responsibility of the exempt organization function, it drained significant resources from the already strained exempt organizations function.

To summarize, EP/EO regulates sectors of the economy that represent \$126.5 billion in annual Federal tax expenditures - an amount equal to approximately twenty-five percent of each dollar of federal tax expenditure. Furthermore, the Joint Committee on Taxation's forecast of federal tax expenditures projects the revenue impact of EP/EO's special tax provisions to be more than \$693 billion between fiscal years 1997 and 2001.²¹

¹⁹ Staff of the Joint Comm. on Taxation, N 6, *supra*.

²⁰ Staff of the Joint Comm. on Taxation, N 6, *supra*.

²¹ Staff of the Joint Comm. on Taxation, N 6, *supra*.

The National Commission on Restructuring the Internal Revenue Service

As noted at the outset of this paper, the 104th Congress authorized a comprehensive review of the nation's tax administration system by creating the National Commission on Restructuring the Internal Revenue Service. The National Commission was charged with reviewing the present practices of the IRS especially with respect to its organizational structure; its paper processing and return processing activities; its infrastructure; and the collection process.²² One of the issues that the National Commission addressed was simplification of the tax administration process. In that context, it considered the various "non-core" functions of the IRS, and received testimony from the author, a former Assistant Commissioner (EP/EO) about the non-tax collection role played by EP/EO.²³ The testimony pointed to areas of risk to the oversight program for EP/EO: personnel, guidance, and returns processing.

With respect to personnel, it was noted that EP/EO's regulatory responsibilities have more than doubled since 1974; that it has assumed compliance responsibility for the \$1 trillion tax-exempt bond sector; and that its' staffing has remained static. The testimony pointed to the 1994 Ways and Means Subcommittee on Oversight report that found the IRS had insufficient resources to adequately regulate public charities, and recommended that the staffing and funding levels allocated for IRS's exempt organizations examination

²² *A Vision for a New IRS*, N2, *supra* at B-2.

²³ "Regulation of EP/EO in the Twenty-First Century," testimony of James J. McGovern before the National Commission on Restructuring the IRS," 16 *EOIR* 209 (1997).

and compliance activities be increased.²⁴ It was also noted that EP/EO was the **only** technical function that was subjected to IRS downsizing and whose employees have received Reduction in Force notification.²⁵

With respect to guidance, it was stated that 94 percent of the 431 exempt organizations revenue rulings published since ERISA were published between 1974 and 1983. The opinion was also offered that tax disputes in examinations of the nation's largest exempt universities and health systems are being resolved on the basis of revenue rulings dating to the 1960s and the 1970s, and that "it is only a matter of time before tax administration in this area becomes dysfunctional."²⁶ The testimony concluded as follows:

While the Service has done a credible job of implementing the mandates of ERISA over the past twenty-two years, it has done so within the confines of a stable IRS budget. In my opinion, a downsized IRS will be unable to balance its tax collection mission with EP/EO's regulatory mission. It is likely that the Service will, of necessity, revert to the pre-ERISA pattern of emphasizing those areas primarily concerned with the production of revenue. As such, I believe that a credible compliance program for these critical areas of our society and economy is in jeopardy.²⁷

²⁴ Reforms to Improve the Tax Rules Governing Public Charities, Hearings Before the Subcommittee on Oversight of the House Committee on Ways and Means, 103rd Cong., 2d Sess. 18-19 (1994).

²⁵ "Regulation of EP/EO in the Twenty-First Century," testimony of James J. McGovern before the National Commission on Restructuring the IRS," 16 *EOTR* 209 (1997).

²⁶ *Id.*

²⁷ *Id.*

A Vision for A New IRS

In its report, *A Vision for a New IRS*, the National Commission addressed the issue of simplifying tax administration by limiting assignment of non-core functions to the IRS. It specifically addressed the EP/EO function and complimented its operations as “one of the most innovative and efficient functions within the IRS.”²⁸ The National Commission recommended that Congress provide sufficient resources to fund EP/EO. The National Commission noted that section 7802(b) was intended to provide EP/EO with an independent source of funding due to its non-tax collection function. The National Commission also noted that “the funding mechanism has never been used, however, and EP/EO constantly struggles with the IRS core tax collection functions for resources to regulate more than \$1.2 trillion in tax exempt assets and \$1.7 trillion in retirement plan assets.”²⁹

H.R. 2292 -- The Internal Revenue Service Restructuring and Reform Act of 1997

On July 30, 1997, H.R. 2292, The Internal Revenue Service Restructuring and Reform Act of 1997, was introduced to implement many of the recommendations of the National Commission. Several provisions addressed the EP/EO operation. The proposed legislation provided for the establishment of the Office of the Assistant Commissioner

²⁸ *A Vision for a New IRS*, N1, *supra*.

²⁹ *Id.*

(EP/EO). The language of this provision differed from the then existing section 7802(b) in two ways. First, it proposed to expand EP/EO's jurisdiction to include nonqualified deferred compensation plans. Second, it proposed that the Assistant Commissioner report to the Commissioner on an annual basis on EP/EO operations. This provision was intended to "restore" the authority of the Assistant Commissioner and the importance of the EP/EO's non-revenue generating function in the tax collection agency.

The proposed legislation also sought to reenact the section 7802(b)(2) funding mechanism by providing for an annual authorization of appropriations equal to the section 4940 excise tax on investment income of private foundations, and the greater of the same amount or \$30 million. In addition, H.R. 2292 would add all user fees collected by EP/EO. The provision differed from the then section 7802(b)(2) in two ways. First, it provided that the appropriation would be used "solely" to carry out the functions of EP/EO. In addition, it would funnel EP/EO user fees to EP/EO operations as opposed to the Treasury general fund.

The Joint Committee on Taxation's September 16, 1997 Analysis

Subsequent to the introduction of H.R. 2292, the Joint Committee on Taxation issued a pamphlet describing the National Commission's proposals.³⁰ Somewhat surprisingly, the

³⁰ Staff of the Joint Committee on Taxation, *Description and Analysis of proposals Relating to the Recommendations of the National Commission on Restructuring the Internal Revenue Service on Executive Branch Governance and Congressional Oversight*, JCX-44-97 (September 16, 1997).

pamphlet contained an **extensive**, 16 page discussion of EP/EO including the formation and structure of the office; its responsibilities; resources, growth of the sector; nature of the EP/EO mandate; and the need for additional resources. The pamphlet confirmed EP/EO's significantly increased responsibilities and limited resources:

As set forth in table 2, the aggregate staffing level remains essentially what it was when EP/EO was formed in 1974. In fact, the staffing level is approximately 20 percent *below* the 1989 peak staffing level. Given the tremendous increase in the number of organizations and plans -- and the value of assets -- within EP/EO's jurisdiction, as well as an expansion of EP/EO's responsibilities to include tax-exempt bonds, the EP/EO staffing level has been a source of Congressional concern in recent years. Twenty years after creation of EP/EO, the Subcommittee on Oversight of the House Committee on Ways and Means concluded that "the IRS does not have sufficient resources allocated to ensure compliance by public charities with applicable tax rules," and recommended that "the staffing and funding levels allocated for IRS's exempt organizations examination and compliance activities be increased to a level consistent with the number, size, and diverse activities of tax-exempt organizations."³¹

³¹ *Id.* at 60.

The Joint Committee also addressed the need for additional resources. It acknowledged, as did the ERISA Congress and the National Commission, that a non-revenue generating function at the IRS would be disadvantaged in the allocation of resources:

Because the IRS does not have infinite financial resources, it must constantly determine how best to allocate its available resources among its myriad functions. Inevitably, such an allocation process will favor the IRS's core tax collection function at the expense of noncore functions. Congress acknowledged this tension at the time it established EP/EO by elevating supervision of the office to an Assistant Commissioner and by dedicating a source of funding for the office. However, the designated funding mechanism has never been utilized and EP/EO along with the rest of the IRS, is funded out of Treasury Department general appropriations.³²

The Joint Committee also recognized, however, that reinstating ERISA's section 7802(b)(2) funding mechanism might be again ignored by the Congressional appropriations process, and might not result in an appropriate amount of funding for EP/EO:

Although the bill attempts to tighten the connection between the excise taxes collected on investment income of private foundations under Code section 4940

³² Id.

and the funding of EP/EO, the office's funding would, as under present law, be subject to the appropriations process and there is no guarantee that the designated amounts actually would be appropriated. Initial legislative intent has been ignored for over twenty years in spite of periodic revisiting of the issue by Congress. Further, the section 4940 excise tax is not without its flaws as a funding source. Because the tax is based on investment income, the amount collected under the tax is very much subject to the vicissitudes of the financial markets. Such uncertainty makes short- and long-range organizational planning difficult. In addition, if the dedication of the section 4940 excise tax to the EP/EO function is deemed appropriate, it may be equally appropriate for other areas of the IRS to retain excise tax collected from taxpayers under their jurisdiction.³³

The pamphlet later acknowledges that while it is not clear that the funding formula set forth in the bill would result in a correct level of funding, **“there appears to be widespread agreement that the current level is too low.”**³⁴

The Joint Committee on Taxation's October 22, 1997 Analysis

On October 22, 1997, the Joint Committee issued another pamphlet in preparation for the Ways and Means mark-up of H.R. 2292. This pamphlet, unlike its predecessor one month earlier, dismissed a dedicated funding provision for EP/EO in a one page analysis:

³³ Id. at 61.

³⁴ Id. at 64.

Because the funding formula for EP/EO set forth in section 7802(b)(2) would, if utilized, result in an unstable level of funding that may bear little or no relation to the amount of financial resources actually required by the EP/EO Division, the proposal would repeal the funding mechanism. Thus, the appropriate level of funding for EP/EO would, consistent with current practice, be subject to annual Congressional appropriations, as are other functions within the IRS. In this regard, however, the proposal would note that, given the magnitude of the sectors EP/EO is charged with regulating, as well as the unique nature of its mandate, an adequately funded EP/EO is extremely important to the efficient and fair administration of the Federal tax system. Accordingly, financial resources for EP/EO should not be constrained on the basis that EP/EO is a "non-core" function; rather, EP/EO, like all functions of the IRS, should be funded so as to promote the efficient and fair administration of the Federal tax system.³⁵

Although the Joint Committee had earlier concurred with the ERISA Congress, with the National Commission, and with the testimony of the former Assistant Commissioner (EP/EO) that a non-revenue generating function at the IRS was disadvantaged in the allocation of operating revenues, it now concluded that EP/EO "like all functions of the IRS, should be funded so as to promote the efficient and fair administration of the Federal tax system."

³⁵ Staff of the Joint Committee on Taxation, *Description of the Internal Revenue Service Restructuring and Reform Act of 1997*, JCX-62-97 (October 21, 1997).

The EP/EO Sector's Participation in the Debate

Following the author's testimony before the National Commission, written comments were submitted to the National Commission and/or Congress by the Exempt Organization Committee, Section of Taxation, District of Columbia Bar;³⁶ the National Council of Nonprofit Associations;³⁷ the Association of the Bar of the City of New York;³⁸ the Council on Foundations;³⁹ the Independent Sector⁴⁰, and the Philanthropy Professors (a group of 34 law professors who teach on the subject on nonprofit organizations).

Noticeably missing from the public debate was any comment from the Exempt Organization ("EO") Committee of the American Bar Association's Tax Section, or any of its past chairpersons. Historically, the ABA's EO Committee had been a progressive sector leader establishing a high public profile on the most important exempt organizations issues.⁴¹ Also notably missing was any comment from the pension community. This is interesting because the National Commission's report was

³⁶ "Comments Concerning the Future Regulation of Employee Plans and Exempt Organization Matters," Taxation Section, the District of Columbia Bar, 16 *EOTR* 1075 (1997).

³⁷ "The Need for Adequate Funding for Nonprofit Regulation and Oversight: A Position paper from the National Council of Nonprofit Associations, 17 *EOTR* 463 (1997).

³⁸ Letter to Representative Bill Archer, Committee on Ways and Means, from Association of the Bar of the City of New York, August 26, 1997, 18 *EOTR* 324 (1997).

³⁹ Letter to Representative Bill Archer, Committee on Ways and Means, from Dorothy S. Ridings, President, Council on Foundations, September 5, 1997, 18 *EOTR* 134 (1997).

⁴⁰ Letter to Representative Bill Archer, Committee on Ways and Means, from Sara E. Melendez, Independent Sector, October 19, 1997, 18 *EOTR* 264.

⁴¹ See, e.g., "White Paper" to Representative Pickle, Committee on Ways and Means, "Comments on Compliance with the Tax Laws by Public Charities," from the Committee on Exempt Organizations, 10 *EOTR* 74 (1994).

particularly complimentary of the voluntary compliance programs established by the employee plans function:

The EP/EO operation is recognized as one of the most innovative and efficient functions within the IRS. In recent years, EP/EO has developed a variety of programs to encourage voluntary compliance, including the voluntary compliance resolution program, the walk-in closing agreement program, and the administrative policy regarding self-correction.⁴²

A meeting was held on October 1, 1997 at the Washington, D.C. office of KPMG Peat Marwick LLP to determine the respective positions of the employee plans and exempt organizations sectors with respect to the recommendations of the National Commission. The meeting was thus held in the period between the two Joint Committee pamphlets. The following organizations were invited to attend: the American Society of Pension Actuaries (ASPA); the Council on Foundations; the Employee Benefits Committee of the American Bar Association; the ERISA Industry Committee ("ERIC"); the EO Committees of the American Bar Association, Association of the Bar of the City of New York, California Bar Association, District of Columbia Bar Association, and Los Angeles Bar Association; the National Council of Nonprofit Associations; the Nonprofit Coordinating Committee of New York; and the Philanthropy Professors. A toll free call in number was provided for those unable to attend, and all but the following

⁴² N2, *supra*.

organizations participated: ASPA, the EO Committees of the California and Los Angeles Bar Associations, and the Philanthropy Professors.

The meeting reflected a clear consensus from the exempt organizations participants that the EO tax administration program was in serious trouble. Most notable was the staffing shortages that were documented in the Joint Committee pamphlet and the defunct exempt organizations guidance program. No such consensus existed in the employee plans community. While the representative of the American Bar Association's Employee Benefits Committee (speaking for himself and not the Tax Section) supported the dedicated funding provision, the other EP representative did not. The ERIC representative stated that while ERIC had not yet taken a position on H.R. 2292, it would vigorously oppose any legislative revision to the section 7802(b)(2) funding mechanism for EP/EO if "one penny" of a revised formula came from the pension sector. The ERIC representative also stated, apparently on behalf of the absent ASPA, that there was continuing bitterness in the small pension plan community over the IRS's extended litigation of the small plan actuarial cases and it would be impossible to gain member support for any funding provision for EP/EO.

Former IRS Commissioner Donald Alexander, the IRS Commissioner at the helm when EP/EO was created, was quoted as saying that trade associations representing the pension sector worked to scuttle the dedicated funding provision to win "brownie points" with their members:

“A couple of pension trades wanted red meat for their members, so they set about defeating this, and lo and behold they did,” Alexander said. According to Alexander, the trade associations told their members that, “IRS is going to impose great, big additional costs on you because they get to keep the costs. We will defeat it for you. Look how great we are. Give us more money.”⁴³

The Joint Committee on Taxation's January 23, 1998 Analysis

Subsequent to the introduction of S. 1096, the Joint Committee on Taxation issued a pamphlet describing the National Commission's proposals.⁴⁴ This pamphlet contained the same extensive discussion of EP/EO that had been initially prepared for the Ways and Means Committee.

The American Bar Association Tax Section February 5, 1998 Letter

On February 5, 1998, the American Bar Association Section of Taxation, in a separate letter supplementing its earlier testimony on the restructuring provisions, urged the Senate Finance Committee to follow the lead of the Ways and Means Committee and repeal the dedicated funding mechanism for EP/EO. The Tax Section noted that the

⁴³ “Could IRS Reorganization Plan Help Exempt Organizations?”, 78 *Tax Notes* 792 (Feb. 16, 1998).

⁴⁴ Staff of the Joint Committee on Taxation, *Description and Analysis of Proposals Relating to the Recommendations of the National Commission on Restructuring the Internal Revenue Service, S. 1096, and H.R. 2676 as passed by the House, JCS-1-98* (January 23, 1998).

section 7802(b) funding mechanism has not been utilized since 1974, and there was no indication that a reenacted provision would be any more effective. In addition, the Tax Section noted that "the dedication of a particular revenue source to fund the EP/EO functions could lead to fluctuations in funding which would make organizational planning difficult."⁴⁵ The letter also expressed concern of Tax Section members that without adequate funding, "the Service's ability to regulate and enforce the tax laws applicable to the employee plans and exempt organizations sectors will be seriously jeopardized."⁴⁶

The Joint Committee on Taxation's March 31, 1998 Analysis

On March 31, 1998, the Joint Committee issued yet another pamphlet on the National Commission's provisions in preparation for the Senate Finance Committee's mark-up of S. 1096.⁴⁷ This pamphlet, unlike its predecessor, not only dismissed a dedicated funding provision for EP/EO, but also proposed to eliminate the section 7802(b) requirement for the Office of Assistant Commissioner (Employee Plans and Exempt Organizations). It would be subsequently explained that the proposed deletion of section 7802(b) came at the request of Commissioner Charles Rossotti so that it would not impede his proposed reorganization of the IRS along functional lines.⁴⁸ The brief two paragraph analysis

⁴⁵ "EP/EO Funding Should Be Part of Annual Budget Process, ABA Tax Section Urges," BNA Daily Tax Report, G-1 (Feb. 18, 1998).

⁴⁶ Id.

⁴⁷ Staff of the Joint Committee on Taxation, *Description of Modifications to Senate Finance Committee Chairman's Mark Relating to Reform and Restructuring of the Internal Revenue Service and Tax Technical Correction Provisions*, JCX-21-98 (March 31, 1998).

⁴⁸ "ABA Tax Section: Petschek, Owens Discuss EP/EO Restructuring, Workplan," 20 EOTR 379 (1998).

would also reflect Congressional concern for the employee plans function -- not for the exempt organizations function:

...it is important to allocate sufficient funds for EP/EO staffing adequately to monitor and assist businesses in establishing and maintaining retirement plans. Recently, in Revenue Procedure 98-22, the IRS announced the expansion of the self-correction programs it offers to employers to encourage companies to identify and correct errors without incurring significant penalties. These changes are welcomed, and it is not intended that the elimination of the statutory requirement contained in section 7802(b)(2) impede the implementation of these and EP/EO's other programs and activities. Rather, it is intended that there be adequate funding for EP/EO, including these self-correction programs that will encourage the establishment and continuation of retirement plans to increase coverage of American workers while protecting the rights of employees to benefits under these plans and maintaining the integrity and purposes of the exemption provisions.⁴⁹

Commissioner Rossotti's Reorganization Plans for the Internal Revenue Service

In testimony before the Senate Finance Committee on January 28, 1998, Commissioner Charles Rossotti presented his vision for a reorganized IRS with a new organizational

⁴⁹ Id.

structure built around taxpayer needs.⁵⁰ Commissioner Rossotti proposed to organize the IRS into four units, each charged with end-to-end responsibility for serving a particular group of taxpayers with similar needs. It is anticipated that these units will replace the four regional offices, many of the district offices, and a substantial part of the national office "to better fulfill its responsibilities of oversight and broad policy rather than operations."⁵¹ The four operating units that are proposed include: wage and investment income; small business and self-employed; large corporations; and employee plans/exempt organizations/state and local government. With respect to the EP/EO operating unit the Commissioner stated:

Finally, the tax exempt sector, including employee plans, exempt organizations and state and local governments, represent a large economic sector with unique needs. Although generally paying no income tax, this sector pays over \$190 billion in employment taxes and withholding for employees and manages \$5 trillion in tax exempt assets. This huge sector will benefit from a dedicated unit that understands its special problems.

The prospect of having one of four IRS operating units focus on the exempt sector is a dramatic proposal that holds significant potential for the regulation of the voluntary sector in the Twenty-First Century. *[TO BE CONTINUED]*

⁵⁰ Statement of Charles O. Rossotti, Commissioner of Internal Revenue, Before the Senate Finance Committee, January 28, 1998, IR 98-3 (1/28/98).

⁵¹ *Id.* at pg. 12.