COMMENTS CONCERNING THE FUTURE REGULATION OF 
EMPLOYEE PLANS AND EXEMPT ORGANIZATION MATTERS 

to be filed with the 
NATIONAL COMMISSION ON RESTRUCTURING THE INTERNAL REVENUE SERVICE 

Prepared by the Exempt Organizations Committee, Section of Taxation 

One-Page Summary for D.C. Bar Reviewers 

The National Commission on Restructuring the Internal Revenue Service, a blue-ribbon commission with a final report due out this summer has received testimony on, among other things, the structure and funding of the Office of the Assistant Commissioner, Employee Plans and Exempt Organizations ("EP/EO"). The Exempt Organizations Committee would like to file comments with the Commission making the following points: 

1. EP/EO is unique within the IRS because collecting tax revenue is not a key part of its mission. Rather, its purpose is to ensure that exempt organizations operate in compliance with the provisions under which they were granted exemption -- in other words, to serve as a regulatory agency for the tax-exempt sector. The tax-exempt sector is also different from other regulated communities, in that, because it relies on the public for its funding, it simply cannot function without public confidence that it is operating in compliance with the law. EP/EO is generally the only national regulatory agency with jurisdiction over incidents of charitable misconduct. It thus plays a critically important role with regard to the functioning of the sector. 

2. The size of the EP/EO workforce has remained static since its inception 23 years ago, while the size of the regulated sector has roughly doubled. 

3. When EP/EO was created, an Internal Revenue Code provision was enacted authorizing the appropriation of collections from certain excise taxes to pay for its operations, but the funds collected have never been appropriated for EP/EO. User fees paid by exempt organizations to receive IRS rulings concerning their activities have also not gone to pay for the costs to EP/EO of providing those rulings. The existence of these mechanisms shows, however, Congressional recognition of the fact that for EP/EO, unlike for other IRS divisions focused on collecting revenue, a self-funding mechanism is appropriate because the regulated sector should bear the cost of the regulation rather than all taxpayers bearing the cost of collecting tax. Ample funds to cover the cost of EP/EO are already generated from excise taxes and penalties paid by exempt organizations. 

4. Recommendation: We therefore recommend that revenues from one or more of the sources below be dedicated to EP/EO as a self-funding mechanism for exempt organization regulation, to the extent needed to ensure a high level of compliance in the tax-exempt sector: 

   (1) the excise taxes originally intended to fund EP/EO 
   (2) the user fees paid for EP/EO rulings and other services 
   (3) penalties paid by exempt organizations for misconduct under the new "intermediate sanctions" legislation 
   (4) penalties paid by exempt organizations for failure to allow public inspection of tax information on request
TAXATION SECTION

The District of Columbia Bar

May 6, 1997

The Honorable J. Robert Kerrey, Co-Chairman
The Honorable Rob Portman, Co-Chairman
National Commission on Restructuring
  the Internal Revenue Service
708 O’Neil House Office Building
Room 300
New Jersey Avenue and C Street, S.E.
Washington, D.C. 20510

Dear Senator Kerrey and Congressman Portman:

On behalf of the Section of Taxation of the District of Columbia Bar,¹ we are providing comments concerning the future regulation by the Internal Revenue Service of employee plans and exempt organizations (“EP/EO”) matters.

We recommend that Congress consider enacting a statute or taking other action that would authorize a self-funding mechanism for the Office of the Assistant Commissioner EP/EO. The various sources that Congress could consider to provide such funding include, among others, the following. First, Congress could direct that the funding mechanism for the Office of the Assistant Commissioner EP/EO contained in section 7802(b)(2)² of the Internal Revenue Code of 1986, as amended (“Code”) be made effective, or alternatively, that an annual appropriation equal to revenues generated from the private foundation net investment income tax imposed under section 4940 of the Code could be used to fund the office of EP/EO. Second, an appropriation equal to revenues generated on an annual basis by user fees for EP/EO services could be used to fund that office. Third, an appropriation equal to revenues generated from excise taxes imposed on excess benefit transactions under new section 4958 of the Code also could be used to fund that office. Fourth, an appropriation equal to revenues generated under section 6652(c) for failure to meet the

¹The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and not those of the District of Columbia Bar or its Board of Governors. The Section of Taxation is comprised of approximately 1,500 members. These materials were prepared by Barbara L. Kirschchen and Cynthia M. Lewin of the Exempt Organizations Committee and approved by the Steering Committee of the Section on Taxation (Judith C. Dunn and Stephen Čontos having recused themselves).

²Section 7802(b)(2) authorizes an appropriation equal to the collections from taxes imposed under section 4940 (based on a 2 percent rate of tax) plus the greater of such amount or $30 million.
The Honorable J. Robert Kerrey, Co-Chairman  
The Honorable Rob Portman, Co-Chairman  
National Commission on Restructuring  
the Internal Revenue Service  
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public inspection requirements of section 6104 and penalties imposed under section 6685 could be used for this purpose.

We recommend that in considering these alternative sources of funding, Congress select one or more that would generate revenues sufficient to cover the cost of the operations of the office of EP/EO at a level adequate to ensure a high measure of compliance in the tax-exempt sector. We further recommend that Congress consider whether additional annual appropriations may be necessary, or whether alternative funding sources should be considered, and that the legislative history of any statutory change would make explicit that these funds would be dedicated to EP/EO operations.

Please contact us if you would like more information about these comments or if we can be of assistance in any other way.

Sincerely,

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Enclosure

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Comments Concerning the Future Regulation of Employee Plans and Exempt Organization Matters
Prepared by the Exempt Organizations Committee
Section of Taxation, District of Columbia Bar1

I. Background and Description of the Problem

A. Unique Role of EP/EO

The Office of the Assistant Commissioner Employee Plans and Exempt Organizations ("EP/EO") is a unique entity within the Internal Revenue Service. It was created by Congress under the Employee Retirement Income Security Act of 1974 because of concerns that the oversight and regulation of employee plans and exempt organizations had been subordinated by the Service to a primary concern of the collection of revenues.2 The fundamental difference between the EP/EO office and other areas of the Internal Revenue Service is that the generation of tax revenue is not a principal part of its mission.3 Rather, the mission of the EP/EO office is to ensure that organizations that qualify for exemption under the Internal Revenue Code conduct their operations so as to comply with the Code provisions under which they are granted exemption -- in other words, to serve as a regulatory agency for the tax-exempt sector.

The need for the EP/EO office to act as a regulatory agency has been underscored in recent years, as the nonprofit community has been repeatedly rocked by highly-publicized scandals. The tax-exempt sector simply cannot function without public confidence that the sector is operating in full compliance with the law. The sector depends for its funding on the public, and the public trust is a critical asset. This was demonstrated most recently by the charitable community's

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2The legislative history of ERISA states “...[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. S. Rep. No. 383, 93rd Cong., 2d Sess. 107-8 (1974). 1974-3 C.B. 186-7.

support for, and indeed urging of, more regulation in the form of intermediate sanctions, in stark contrast to the behavior of most other regulated sectors. The EP/EO office is generally the only national regulatory agency with any jurisdiction over incidents of charitable misconduct. While state Attorneys General have some oversight responsibilities, many states are unable to devote significant resources to this area, and it can be difficult for one state to grapple with an organization that conducts its operations nation-wide. EP/EO’s role in ensuring that the sector is worthy of the public trust is therefore essential to the functioning of the sector.

B. **Growth of the Tax-Exempt Sector to be Regulated**

Since the EP/EO office was created, the number of tax-exempt organizations for which it is responsible has grown by 60 percent, from 690,000 to 1.1 million.\(^4\) The number of workers in retirement plans for which it is responsible has more than doubled.\(^5\) In addition, in 1993, the EP/EO office assumed responsibility for the oversight of the Service’s tax-exempt bond compliance program, with outstanding tax-exempt debt of approximately $1.2 trillion and tax expenditures for 1997 estimated to be $22 billion.\(^6\) Further, the past 20 years have seen an absolute deluge of new legislation in the employee plan area, with significant legislative developments in the exempt organizations area as well. Yet the EP/EO workforce assigned to ensure compliance of this sector has not grown correspondingly. In fact, it has hardly grown at all. EP/EO had 2,075 employees in 1975 and 2,229 in 1996 -- a growth of 7 percent in employees to regulate an exempt organization sector that grew 60 percent in the same time period.\(^7\)

Moreover, the EP/EO national office, charged with setting national policy in the EP/EO area, has been cut by a third in recent years, and further reductions are currently taking place.\(^8\) The basic premise underlying the United States tax system is voluntary compliance. The tax rules applicable to exempt organizations are complicated, and the administration of these laws must be consistent and even-handed if voluntary compliance is to work. Consistent administration in turn requires a strong EP/EO national office to create uniform interpretations of the law, to oversee field personnel working in the area, and to set priorities. Practitioners see significant disparities among Key Districts in their interpretations and enforcement of the law, making it difficult for the

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\(^4\) See McGovern, supra at 210.

\(^5\) Id.

\(^6\) Id.

\(^7\) See McGovern, supra at 211.

\(^8\) Id.
EP/EO national office to bring about the desired consistent and even-handed administration and achievement of national objectives.  

The unique role of EP/EO as a regulatory agency and the importance of public confidence in the tax-exempt sector provide a compelling need for sufficient funding for EP/EO to carry out its mission. Accordingly, we propose that revenues generated from enforcement in the exempt organizations area should be used, in effect, to help create and enforce a self-funded policing system.

II. Possible Dedicated Funding Sources

A. Section 4940 Excise Tax on Net Investment Income of Private Foundations

When the position of Assistant Commissioner (EP/EO) was codified in section 7802(b) in 1974, Congress recognized that the responsibilities of this new position would require a substantial increase in staffing. Accordingly, section 7802(b)(2) authorized an annual appropriation equal to one-half of the then section 4940 net investment income tax imposed on private foundations (at that time, a four percent rate), plus the greater of the same amount or $30 million for funding for the new EP/EO office. Although there appears to be no public record that the funding mechanism in section 7802(b)(2) was ever repealed, this mechanism has never been made effective, and thus EP/EO was never funded by revenues reflecting amounts generated by the section 4940 excise tax.  

Indeed, the legislative history of section 4940 itself indicates that that excise tax was essentially intended to be an audit or user fee to pay for the cost of regulating private foundations. The Senate Finance Committee viewed the tax “as an indication of the amount of

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2See ABA Section of Taxation Committee on Exempt Organizations “White Paper,” “Comments on Compliance with the Tax Laws by Public Charities,” reprinted at 10 The Exempt Organization Tax Review, No. 1 at 74 (July 1994).

10According to the testimony of James J. McGovern, former Assistant Commissioner for EP/EO before the Restructuring Commission, the failure to use “the section 7802(b)(2) funding mechanism for EP/EO would prove to be a fatal flaw in the design of a separate organizational unit within the IRS.” McGovern at 210.

11One of the justifications for the tax as explained in the legislative history of the Tax Reform Act of 1969 was that “... it is clear that vigorous and extensive administration is needed in order to provide appropriate assurances that private foundations will promptly and properly use their funds for charitable purposes.” H.R. Rep. No. 413, 91st Cong., 1st Sess. Pt I, at 19 (1969), reprinted in 1969-3 C.B. 213. Moreover, the Senate Finance Committee agreed with the House that private foundations should be subject to and bear the costs of close scrutiny and supervision. According to the Senate Finance Committee Report, “[t]he Committee agrees with the House that
funds needed by the Internal Revenue Service for proper administration of the Internal Revenue Code provisions relating to private foundations and other exempt organizations. However, section 4940 does not create a fund specifically designated to be used to recover amounts spent by the Service on increased audit programs that would result from enactment of the private foundation rules. Nonetheless, the taxes collected under section 4940 as initially enacted apparently regularly exceeded the Service’s costs not only for audit programs for private foundations but also for all of the Service’s programs relating to exempt organizations.

B. Exempt Organization Services User Fees

As a result of the Revenue Act of 1987, exempt organizations and employee plans that make various requests to the Service have, since February 1, 1988, been required to pay specific user fees to the Service. With respect to exempt organizations, these include requests to change accounting periods that are made on Form 1128, requests to change accounting methods made on Form 3115, and other requests for rulings, including, among others, initial exemption applications under Section 501, group exemption letters, requests to modify terms or stipulations in an initial exemption determination letter, advance approval of scholarship grant-making procedures by certain private foundations, and requests for termination of private foundation status. The proceeds for EP/EO services user fees (which range from $25 million to $70 million per year) go to the general Treasury fund.

private foundations should be subject to substantial supervision, of the type appropriate to their receipt of tax benefits under the Internal Revenue Code. It also agrees that the costs of this supervision should not be borne by the general taxpayer, but rather should be imposed on those exempt organizations whose activities have given rise to much of the need for supervision. Accordingly, the committee agrees that an annual tax should be imposed upon private foundations.”


12 See S. Rep. No. 1263, 95th Cong., 2d Sess. 218 (1978), to the effect that since its enactment, the Section 4940 tax produced more than twice the revenue needed to finance the Service’s operations with respect to tax-exempt organizations. See also Staff of Joint Comm. On Tax’n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 672 (Comm. Print 1984) to the effect that in 1982, the Service’s costs of administering programs relating to all exempt organizations were $33.4 million, while Section 4940 taxes totaled $93.2 million.


15 See McGovern, supra at 210.
C. **Section 4958 Excise Tax on Excess Benefit Transactions**

The Taxpayer Bill of Rights 2, signed by the President on July 30, 1996, imposes penalty excise taxes as an intermediate sanction where organizations exempt from tax under section 501(c)(3) or 501(c)(4) (other than private foundations, which are subject to a separate regime of penalties under current law) engage in an “excess benefit transaction.” In such cases, intermediate sanctions may be imposed on certain disqualified persons who improperly benefit from an excess benefit transaction and on organization managers who participate in such a transaction knowing that it is improper. The new law generally applies to excess benefit transactions occurring on or after September 14, 1995.16

D. **Section 6652(c) and 6685 Public Inspection Penalties**

The Taxpayer Bill of Rights 2 increased the section 6652(c)(1)(C) and (D) penalties imposed on persons that fail to allow public inspection or provide copies of certain annual returns or exemption applications to $20 per day (with a maximum of $10,000). The new law also increases the section 6685 penalty for willful failure to allow public inspections or provide copies to $5,000.

III. **Recommendations**

As discussed above, the Office of the Assistant Commissioner Employee Plans and Exempt Organizations has a unique role within the Internal Revenue Service (i.e., ensuring that tax-exempt organizations comply with the conditions under which they obtained their exemption, rather than primarily generating revenue). Moreover, the legislative history of numerous Code provisions concerning tax-exempt organizations indicates that Congress has long been aware that while tax-exempt organizations should be subject to substantial scrutiny and supervision, those organizations -- rather than the general taxpayer -- should bear the costs of such scrutiny and supervision. Existing excise taxes and penalty provisions applicable to tax-exempt organizations provide ample revenues to fund the operations of EP/EO. Accordingly, we recommend in general, that Congress should authorize a self-funding mechanism for the Office of the Assistant Commissioner for Employee Plans and Exempt Organizations utilizing existing revenue sources. This mechanism would include (among other provisions that Congress deems appropriate) appropriations equal to revenues generated from one or more of the following:

16 Because the law is so new, it is unclear how much revenue the excise tax will generate. The Joint committee on Taxation estimated that the tax would generate $4 to $6 million per year. See H. Rep. No. 506, 104th Cong. 2d Sess. 64 (1996).
A. Annual Appropriation Equal to Annual Revenues Generated from the Section 4940 Net Investment Income Tax on Private Foundations

We recommend that Congress direct that the funding mechanism for the office of EP/EO contained in section 7802(b)(2) be made effective. Alternatively, if that provision cannot be made effective, we recommend that Congress consider enacting a statute authorizing an annual appropriation equal to annual revenues generated from the private foundation net investment income tax imposed under section 4940 of the Code to be used to fund the office of EP/EO. As is clear from the legislative history of section 7802(b) under which the position of Assistant Commissioner EP/EO was created, Congress recognized that the responsibilities of this position would require a substantial increase in staffing. Moreover, the legislative history of section 4940 itself indicates that the original purpose of the excise tax was to be a fee to pay for the cost of regulating private foundations. The history of subsequent legislation addressing section 4940 indicates that the Service's costs in administering programs relating to all exempt organizations were substantially less than revenue generated by the section 4940 taxes. Amounts derived from such taxes that are sufficient to cover the operations of the EP/EO office could be devoted to IRS oversight of exempt organizations.

B. Annual Appropriation Equal to Annual Revenues Generated from EP/EO Services User Fees

Similarly, if additional revenue is needed, we recommend that Congress consider enacting a statute authorizing an annual appropriation equal to revenues generated on an annual basis by user fees for EP/EO services to be used to fund the office of EP/EO. Because these fees are paid to the IRS by exempt organizations in order to comply with current law, or to obtain advice from the IRS to ensure that they are in compliance, the effective use of such fees to fund the EP/EO office could be considered as a funding mechanism that compliant exempt organizations make to help monitor the entire exempt organization sector. Further, such treatment would be consistent with the notion of a user fee -- a payment to help defer the cost of the service being provided to the payor.

C. Annual Appropriation Equal to Annual Revenues Generated from Excise Taxes Imposed on Excess Benefit Transactions

We further recommend that if additional revenue is needed, Congress consider enacting a statute authorizing an annual appropriation equal to the annual revenues that will be generated by the new excise tax imposed on excess benefit transactions to fund the EP/EO office. Although as of this date, it is unclear the amount of revenues that the new excise tax will generate, the taxes are, in effect, penalties imposed on disqualified persons and organization managers who have been involved in transactions in which the assets of a section 501(c)(3) public charity or section 501(c)(4) organization are improperly used for private benefit. As part of a self-funded enforcement mechanism, such penalties logically could be used to assist the Service in fulfilling its oversight obligations of exempt organizations.
D. Annual Appropriation Equal to Annual Revenues Generated from Penalties Imposed for Failure to Meet Filing or Public Inspection Requirements

Similarly, we recommend that Congress consider enacting a statute authorizing an annual appropriation equal to revenues generated from penalties imposed under section 6652 on the failure to meet the public inspection and copying requirements of section 6104, and the section 6685 willful failure to allow public inspections or to provide copies of certain annual information returns or exemption applications. Again, such penalties logically should be used for such a purpose under a self-funding enforcement mechanism in the exempt organizations area.