Advisory Committee on Tax Exempt and Government Entities (ACT)

Report of Recommendations

Public Meeting
Washington, DC
June 15, 2011

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Public Meeting
1111 Constitution Ave., NW
Washington, DC 20224
June 15, 2011

Agenda

Welcome and Opening Remarks:

- Douglas H. Shulman, Commissioner of Internal Revenue Service
- Joseph H. Grant, Acting Commissioner, Tax Exempt and Government Entities
- Roberta Zarin, Designated Federal Official of the ACT
- Michael G. Bailey, Chair of the ACT

Reports of Recommendations:

- Tax Exempt Bonds: The Role of Conduit Issuers in Tax Compliance

- Federal, State and Local Governments: Review of the Government Accountability Office (GAO) Report to Congressional Requesters Entitled "Social Security Administration – Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees"

- Federal, State and Local Governments: Evaluation of, and Recommendations for Improvement to, the Federal, State and Local Governments (FSLG) Website

- Indian Tribal Governments: Supplemental Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009

- Indian Tribal Governments: Survey of Issues Requiring Administrative Guidance in the Wake of Enactment of Section 906 of the Pension Protection Act of 2006

- Exempt Organizations: Group Exemptions – Creating a Higher Degree of Transparency, Accountability, and Responsibility

- Employee Plans: Recommendations Regarding Pension Outreach to the Small Business Community

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Member Biographies
2010-2011

EMPLOYEE PLANS

Barbara A. Clark, Oakland, CA

Ms. Clark is the benefits counsel for the retirement and health and welfare plans sponsored by the University of California, a state government agency and 501(c)(3) organization. The University provides a defined benefit pension plan and three defined contributions plans for its 124,000 employees and 41,000 retirees. Before joining the University in 2003, Ms. Clark had more than 20 years experience as an employee benefits attorney in the private sector. Ms. Clark received her Juris Doctorate from the Boalt Hall School of Law and is a member of the California State Bar.

Kathryn J. Kennedy, Chicago, IL

Ms. Kennedy is the Associate Dean for Advanced Studies and Research and Professor of Law at the John Marshall Law School. As the Director for the Center for Tax Law & Employee Benefits at the school, she established the first LLM program in the nation for Employee Benefits and has since developed the curriculum for more than 20 employee benefits courses. Ms. Kennedy served for three years on the Department of Labor's ERISA Advisory Council and co-authored an employee benefits law textbook. She received her Juris Doctorate from the Northwestern University School of Law, *summa cum laude,* and her Fellowship from the Society of Actuaries. Ms. Kennedy is also a Fellow of the American College of Employee Benefits Counsel and was the 2009 ASPPA Educator of the Year.

David N. Levine, Washington, D.C.

Mr. Levine is a principal at Groom Law Group, Chartered, where he provides ongoing employee benefit-plan advice to a number of tax-exempt, for-profit and governmental entities, as well as service-providers to these entities. In representing plan sponsors and service providers, he addresses both technical plan design and general administrative, recordkeeping, and "process" issues that are common to many plan sponsors. He has served as the Vice Chair of the Legislative Subcommittee of the ABA Tax Section's Employee Benefits Committee. Mr. Levine received a Juris Doctorate from the University of Pennsylvania Law School.

G. Daniel Miller, Washington, D.C.

Mr. Miller is a partner in the Washington, D.C., office of Conner & Winters LLP, and a member of that firm's Employee Benefits Practice Group. As a specialist in employee benefits for more than 30 years, he serves the needs of both large and small for-profit employers and the deferred compensation planning needs of a variety of non-profit employers. He is also a Fellow in the American College of Employee Benefits Counsel and a member of the Employee Benefits Committee of the Tax Section of the American Bar Association. Mr. Miller received his Juris Doctorate from the Vanderbilt University School of Law.

Adam C. Pozek, Reading, MA

Mr. Pozek is a partner at DWC ERISA Consultants, LLC. He specializes in plan design, qualified-plan-related due diligence in mergers and acquisitions transactions, and corrections under the Service's Employee Plans Compliance Resolution System. Mr. Pozek is active in the American Society of Pension Professionals and Actuaries where he serves on the board of directors, executive committee and government affairs committee. He also serves as co-editor-in-chief of the Journal of Pension Benefits. Mr. Pozek studied accounting and finance at Georgia State University, and he is enrolled to practice before the IRS as an Enrolled Retirement Plan Agent.

Susan P. Serota, New York, NY

Ms. Serota is a partner in the New York office of Pillsbury Winthrop Shaw Pittman LLP and chair of the firm's Executive Compensation and Employee Benefits practice. She has broad experience in complicated tax issues and analysis, including defined benefit plans, hybrid plans, section 409A non-qualified deferred compensation arrangements, and section 457 deferred compensation plans for tax exempt and government entities. In 2006 – 2007, she served as the Chair of the American Bar Association Section of Taxation. Ms. Serota received her Juris Doctorate from the New York University School of Law.

EXEMPT ORGANIZATIONS

J. Daniel Gary, Nashville, TN

Mr. Gary is Administrative Counsel for the General Council on Finance and Administration (GCFA) of The United Methodist Church, the third largest religious denomination in the United States. GCFA is responsible for protecting the legal interests of the denomination. Mr. Gary provides guidance on a wide variety of issues related to tax-exempt organizations, including charitable giving, legislative and political campaign activities, and unrelated business income tax. Mr. Gary received his Juris Doctorate from the Washington and Lee University School of Law and his Ph.D. in mathematics from the University of Illinois.

Karen A. Gries, Minneapolis, MN

Ms. Gries is a principal with Larson Allen LLP where she works with a wide variety of tax-exempt organizations, including charities, social welfare organizations, business leagues and associations, credit unions, health care providers, and religious organizations. She has extensive experience in unrelated business income tax planning and reporting, intermediate-sanction analysis as well as application and corporate compliance review. Ms. Gries is a graduate of Nettleton College in South Dakota.

Karin Kunstler Goldman, New York, NY

Ms. Goldman is Assistant Attorney General in the Charities Bureau of the New York State Department of Law, where she has a wide range of responsibilities in the oversight of tax-exempt entities. She is responsible for the Bureau's public education program and has also coordinated multi-state enforcement actions. She is a past president of the National Association of State Charities Officials (NASCO), and has been active in conducting educational seminars for officers, employees, and volunteers of exempt organizations throughout the State of New York. Ms. Goldman holds a Juris Doctorate from Rutgers Law School.

James P. Joseph, Washington, D.C.

Mr. Joseph is a partner and the head of the tax-exempt organizations practice at Arnold & Porter LLP. In the past 15 years, he has focused on representing tax-exempt organizations, and has advised public charities, colleges and universities, private foundations and advocacy groups on a variety of issues, including operating business ventures, conducting international activities and grant-making, lobbying and advocacy, nonprofit governance, and executive compensation. His practice has involved several high-profile matters that have had broad impact on the nonprofit sector. Mr. Joseph received his Juris Doctorate from the Georgetown University Law Center and is currently Co-Chair of the American Bar Associations Subcommittee on Intermediate Sanctions.

Cella Roady, Washington, D.C.

Ms. Roady is a partner in Morgan Lewis & Bockius, LLP, where she works on a wide range of issues affecting public charities, private foundations and other categories of tax-exempt organizations. Among other entities, she represents colleges and universities, museums, private and operating foundations, scholarship organizations, and disaster relief organizations. Ms. Roady received her Juris Doctorate from the Duke University School of Law and her LLM from the Georgetown University Law Center.

Jack B. Siegel, Chicago, IL

Mr. Siegel is an attorney (Illinois and Wisconsin) and Certified Public Accountant (Wisconsin) with 25 years experience in providing educational, consulting, and legal services, focusing on nonprofit governance, financial matters, and tax issues. As the Principal of Charity Governance Consulting LLC, he has provided counsel to nonprofit organizations pertaining to complex investment vehicles; and as a CPA he is an expert in nonprofit accounting. Mr. Siegel also has extensive experience in developing computer-based training software for lawyers, accountants, and nonprofit directors and officers. Mr. Siegel received an LLM in Taxation from the New York University School of Law, and a Masters of Business Administration from the Kellogg Graduate School of Management, Northwestern University.

GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS

Paul Carlson, Los Angeles, CA

Mr. Carlson is the Vice President, Administrative Services, at Los Angeles City College, where he oversees accounting, budgeting, facilities, security, auxiliary services, custodial and landscaping functions at the College. Previous to joining the College in 2010, he was the Nebraska State Accounting Administrator and the State Social Security Administrator for ten years, responsible for the comptrollership functions for the State. He has been active in the National Association of State Comptrollers, recently serving as its president. Mr. Carlson is a Certified Public Accountant and has completed the coursework for a Ph.D. in Educational Administration at the University of Nebraska, and holds a Masters of Business Administration from the University of Montana.

Maryann Motza, Denver, CO

Ms. Motza is the State Social Security Administrator of Colorado, where she works closely with all state and local governments' employers, and their financial and legal advisors, to ensure compliance with federal Social Security, Medicare, and public pension system laws. She was President of the National Conference of State Social Security Administrators (NCSSSA) in 2001-2002, and again during 2010-2011. She was also a member of the IRS's Taxpayer Advocacy Panel (2004 – 2007). She currently serves as a member of the Board of Trustees for the Public Employees' Retirement Association of Colorado (since 2005). Ms. Motza has a Ph.D. in Public Affairs from the University of Colorado.

Patricia A. Phillips, Virginia Beach, VA

Ms. Phillips is Director of Finance for the City of Virginia Beach, where she oversees accounting, payroll, purchasing, risk management, and debt administration for the city. She has served on the Government Financial Officers Association (GFOA) Standing Committee on Debt Management, the GFOA Standing Committee on Economic Development and Capital Planning, as well as the GFOA Executive Board. Ms. Phillips is a Certified Public Accountant and a Certified Government Financial Manager. Ms. Phillips holds a Masters in Business Administration from Old Dominion University.

GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS

Joe Lennihan, Santa Fe, NM

Mr. Lennihan is an attorney with one of the largest law firms in New Mexico. He has worked in the Tax Unit of the Navajo Nation Department of Justice and served as general counsel to the Colorado River Indian Tribes. He has also served as Chief Counsel to the New Mexico Taxation and Revenue Department. Mr. Lennihan received his LLM from Georgetown University Law School.

Wendy S. Pearson, Seattle, WA

Ms. Pearson has more than 20 years' experience as a former IRS attorney and a taxpayer representative, and has handled numerous Indian tribal government matters, including constructive receipt, taxation of member benefit programs, and withholding and information reporting. She also consults nonprofit entities, hospitals, and health care organizations on matters like governance, excess benefit transactions, executive compensation, and tax-exempt financing. In her practice, she regularly consults with tribes and their representatives on tax issues. Ms. Pearson received her LLM in Taxation from the University of Florida School of Law and her Juris Doctorate from the Gonzaga School of Law in Spokane, WA.

GOVERNMENT ENTITIES: TAX EXEMPT BONDS

Michael G. Bailey, Chicago, IL

Mr. Bailey is a partner with Foley & Lardner LLP in Chicago, specializing in public, health care, and tax-advantaged finance. He has represented a wide variety of state and local governments and exempt organizations. He is the Chair of the Committee on Tax Exempt Financing of the Section of Taxation of the American Bar Association. From 1990 through 1997, he was senior attorney in the Office of the Chief Counsel of the IRS. Mr. Bailey holds a Juris Doctorate from the University of Chicago Law School.

David Cholst, Chicago, IL

Mr. Cholst is a partner in the tax department of Chapman and Cutler LLP, where he provides tax advice relating to tax-exempt bonds, Build America Bonds, and tax credit bonds. He is also in charge of his firm's rebate computation service. Mr. Cholst represents governmental issuers, underwriters, investment brokers, and attorneys in all matters relating to tax-exempt bonds, including arbitrage rebate. His governmental clients include both large and small municipalities. He has been a member of the faculty of the National Association of Bond Lawyers Tax Seminar and is a member of the ABA Tax Exempt Finance Committee. Mr. Cholst received his Juris Doctorate from the University of Chicago Law School.

George T. Magnatta, Philadelphia, PA

Mr. Magnatta is the chair of Saul Ewing LLP's public finance practice and an experienced practitioner in the tax aspects of public finance. His practice focuses on serving as bond counsel, underwriter's counsel, borrower's counsel, and tax counsel for states, cities, economic development authorities, housing authorities, and nonprofit entities. Mr. Magnatta served as Assistant Branch Chief of the Office of Chief Counsel, Legislation and Regulations Division of the IRS (1981-85). He is a frequent panelist at meetings of the National Association of Bond Lawyers. He is the co-author of *ABCs of Industrial Development Bonds* (5th Edition). Mr. Magnatta received his Juris Doctorate from Temple University, and an LLM in Taxation from the Georgetown University Law Center.

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

This General Report is presented in connection with the tenth annual public meeting of the Internal Revenue Service Advisory Committee on Tax Exempt and Government Entities (the "ACT"). The Tax Exempt and Government Entities (TE/GE) division of the Service consists of functions responsible for the administration of federal tax laws related to exempt organizations, employee plans, tax exempt bonds, Indian tribal governments, and federal, state and local governments. The ACT is established to provide an organized public forum for discussion of issues relevant to the responsibilities of the TE/GE division and to enable the Service to receive regular input with respect to the development and implementation of tax administration issues affecting the communities served by the TE/GE division.

One of the ACT's main activities has been a series of year-long projects on specific topics that culminate in the final recommendations and report presented at the June public meeting each year. This year's projects are:

Tax Exempt Bonds

- The Role of Conduit Issuers in Tax Compliance

Federal, State and Local Governments

- Review of the Government Accountability Office (GAO) Report to Congressional Requesters Entitled "Social Security Administration – Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees"
- Evaluation of, and Recommendations for Improvement to, the Federal, State and Local Governments (FSLG) Website

Indian Tribal Governments

- Supplemental Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009
- Survey of Issues Requiring Administrative Guidance in the Wake of Enactment of Section 906 of the Pension Protection Act of 2006

Exempt Organizations

- Group Exemptions: Creating a Higher Degree of Transparency, Accountability, and Responsibility

Employee Plans

- Recommendations Regarding Pension Outreach to the Small Business Community

Marking the ten-year anniversary of the ACT, the individual reports are in the best tradition that the ACT has established since its formation.

The TE/GE division has a unique mission within the Service, and deals with a unique set of stakeholders and administrative challenges. The ACT was established in large part in recognition of these unique challenges.

Probably more so than other divisions of the Service, TE/GE has responsibility to administer federal tax rules that in effect delegate tax compliance responsibilities to stakeholders other than the Service. In this regard, the individual reports of the Exempt Organizations subcommittee and the Tax Exempt Bonds subcommittee in particular address similar compliance challenges. The individual report on Group Exemptions in large part considers the role of the central organization that has received a group exemption letter to supervise or control its subordinate organizations. The report notes that "[i]n effect, the IRS has 'deputized' central organizations as agents of the IRS, but has done so without guidance, training or oversight." The report then makes a series of recommendations regarding elements of best practices in this area. Similarly, the individual report on the Role of Conduit Issuers considers the compliance role of state and local issuers of tax-exempt, "conduit financing bonds," which make loans to borrowers, including section 501(c)(3) organizations, for-profit corporations or other local governments. The report notes that the Internal Revenue Code in effect deputizes conduit issuers to serve an important oversight function relating to tax-exempt bonds, but that further guidance and discussion are needed to clarify that function. The report then, in a manner similar to the Group Exemptions report, makes a series of recommendations relating to best practices. Both of these reports recognize that a range of different compliance approaches may be entirely appropriate for such 'deputized' stakeholders.

By striking coincidence, the laws relating to central organizations receiving group exemption letters and conduit issuers of tax-exempt bonds are both based on foundations laid in 1968 (in the case of group exemption letters a revenue procedure published in that year and in the case of conduit issuers legislation enacted in that year). In the 43 years since these legal foundations were laid, many fundamental questions regarding the tax compliance roles of these unique stakeholders have remained unresolved and unexplored.

The individual report of the Federal, State and Local Governments subcommittee on Review of the Government Accountability Office (GAO) Report to Congressional Requesters Entitled "Social Security Administration – Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees" similarly addresses the question of how the Service can better interact with a unique stakeholder. That report considers the Service's role in the complex framework established under section 218 of the Social Security Act. The report emphasizes that effective tax administration requires not only better coordination between the Service and the Social Security Administration, but also with State Social Security Administrators (and their national association). The report makes a number of specific

recommendations regarding how State Social Security Administrators can be better woven into an effective system of compliance.

These three reports in particular are prime examples of why a formal advisory committee is particularly appropriate for the TE/GE division: the unique issues and stakeholders that TE/GE deals with require approaches and solutions that are often unique within the federal tax system.

The individual report of the Employee Plans subcommittee on Recommendations Regarding Pension Outreach to the Small Business Community is the latest in an impressive line of ACT reports that attempt to facilitate efforts to make complex federal tax rules understandable and workable for relatively small taxpayers. This report also includes a strong theme of emphasizing the need for the Service to partner with other stakeholders, including in connection with the creation of a retirement plan clinic. This emphasis on proposals to partner with other organizations is also in the spirit of many prior ACT reports.

Similarly, one of the individual reports of the Indian Tribal Governments subcommittee emphasizes the need for better coordination between the Service, the Department of Labor, and the Pension Benefit Guaranty Corporation. That report addresses the development of laws relating to tribally-sponsored employee pension plans over the past several decades and highlights the conflicting and uneven treatment of these plans.

The Indian Tribal Governments subcommittee also prepared a Supplemental Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009. This supplemental report is in the tradition of many ACT reports that have built upon, and expanded, the recommendations of prior year's reports.

The Federal, State and Local Governments subcommittee prepared a second report on Evaluation of, and Recommendations for Improvement to, the Federal, State and Local Governments (FSLG) Website. This report is an example of how the ACT has reached out to stakeholders to gather input that can lead to practical improvements in tax administration.

A Ten-Year Retrospective of the ACT

The ten-year anniversary of the ACT is an occasion to review and consider the accomplishments and direction of the ACT. As a part of this retrospective, a survey questionnaire was sent to prior and current members to ask for their assessment of the ACT. The following are highlights of, and some comments on, those responses.

Contributions of the ACT. Nearly all responding ACT members expressed the view that the ACT has made substantial contributions to tax administration and that the contributions of the ACT have more than merited its administrative cost.

Functions of the ACT. All of the responding members expressed the view that an important role of the ACT is to serve in an advisory role for ongoing matters, in addition to the preparation of annual reports. Many members expressed the view that their role acting as a "sounding board" was even more important than in the preparation of annual reports. The responses indicate, however, that the extent to which Service staff has utilized the ACT as a sounding board has varied significantly from year to year and from subcommittee to subcommittee. The responses indicate that new ACT members, as well as Service staff, would benefit from a fuller description of the different roles ACT members have served.

Projects of the ACT. The individual reports of the ACT have ranged from scholarly "white papers" (for example, the 2008 Exempt Organizations subcommittee report on the appropriate role of the Service with respect to tax-exempt organization good governance issues) to "nuts-and-bolts" recommendations for implementation of specific procedures (for example, the 2010 Tax Exempt Bonds subcommittee report on voluntary resolution procedures for Build America Bonds and other tax credit bonds). On the whole, the many different approaches to ACT reports appear to have been helpful to the Service, and to have enabled ACT reports to make different types of contributions to tax administration.

An attempt to summarize all of the significant ACT reports is beyond the scope of this summary. Responding members, however, highlighted a number of ACT reports in particular, including the 2002 individual report on the life cycle of a public charity, the 2005 individual report on establishing the enrolled retirement plan agent under Circular 230 and the 2009 individual report on tax-exempt bond record retention and post-issuance compliance.

Implementation of ACT recommendations. The TE/GE division has implemented a significant number of the recommendations made in ACT reports. For example, in the Employee Plans area, the Service has implemented recommendations relating to the enrollment of enrolled retirement plan agents and the development of a section 403(b) pre-approved plan program. In a more recent example, the TE/GE division recently implemented recommendations made in the Federal, State and Local Governments subcommittee report for a verification checklist for public employers.

The Service has not adopted recommendations for a number of different reasons. In some cases, the TE/GE division appears to have considered the recommendations made, but simply disagreed with them. For example, the TE/GE division appears to have disagreed with recommendations relating to a voluntary resolution program for exempt organizations and relating to the approach to Form 990. It would appear to be entirely expected and appropriate that the Service would not necessarily agree with, and implement, all recommendations made by an advisory committee.

In other cases, the Service appears not to have adopted recommendations because of delays relating to the need to coordinate with the Office of Chief Counsel or other functions within the Service.

"Interdisciplinary" projects and approaches. Many organizations are faced with challenges on how to foster better communication and collaboration between their different departments and disciplines. The TE/GE division is no exception. With some notable exceptions, the ACT has not consistently served the purpose of "breaking down silos" between the different technical areas served by TE/GE, and has not played a significant role in helping TE/GE to develop "cross-cutting" projects, strategies and approaches. The member respondents had mixed views on whether this is important. Approximately half of the respondents expressed the view that development "silo-breaking" projects should not be a primary focus of the ACT, and that attention is better focused on developing projects within separate technical areas. Others strongly expressed the view that the ACT needs to renew its commitment to continue efforts to make connections between the different parts of the TE/GE division. One possible conclusion is that the ACT will likely only make headway on "silo-breaking" projects if it is strongly encouraged to do so by the Service. If such "silo-breaking" projects and approaches are viewed as a priority for the Service, the Service may wish to consider revising the ACT's charter accordingly and to consider appointing new members who express an interest in such projects and approaches.

Special Thanks

Nine members of the ACT are completing their terms this year:

- Michael G. Bailey
- Paul Carlson
- Karin Kunstler Goldman
- Joe Lennihan
- G. Daniel Miller
- Maryann Motza
- Patricia A. Phillips
- Susan Serota
- Jack Siegel

Each of these members has made a significant contribution to the ACT. The continuing members and I would like to thank them for their service, dedication and commitment to the ACT and also for their friendship.

On behalf of the members of the ACT, I would like to thank Commissioner Doug Shulman for his interest in and support of the ACT. Also, I would like to thank in particular TE/GE Commissioner Sarah Hall Ingram, Deputy Commissioner Joseph Grant (who is currently serving as TE/GE Commissioner) and the TE/GE division directors and their staffs. The success of the ACT critically depends on willingness of public servants within the TE/GE division to work with the ACT.

On behalf of the current and all prior members of the ACT, I would like to extend a special thanks to Steven J. Pyrek, who served as the ACT's Designated Federal Official from its formation, to his retirement in 2010. His effective handling of all of the administrative details associated with the ACT was essential to the ACT's achievements. On behalf of the current members of the ACT, I would also like to thank Roberta Zarin, the ACT's new Designated Federal Official, who has ably succeeded Steve Pyrek.

Finally, I would like to thank the Vice-Chair of the ACT, Maryann Motza, for all of her dedication and service to the ACT.

We recognize that membership on the ACT represents a special opportunity to serve the public and are grateful to have been given this opportunity. We hope that our work was helpful to the Service and to the constituencies we both serve.

Michael G. Bailey
Chair

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Tax Exempt Bonds:
The Role of Conduit Issuers in Tax Compliance

Michael Bailey
David Cholst
George T. Magnatta

June 15, 2011

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Executive Summary

Tax-exempt bonds and tax credit bonds are required to be issued by a State or local government, even in cases where the real obligor and beneficiary of the financing is permitted to be an entity other than a State or local government. In addition, certain State or local government bonds are issued for the purpose of making loans to other local governments. Tax-exempt bonds and tax credit bonds that are issued for the purpose of making loans to other entities are referred to as "conduit issues," and the State or local governments that issue such bonds are referred to as "conduit issuers."

Legislative history indicates that Congress intends that conduit issuers play an important oversight role, but the aspects of that role have not been completely defined by the Internal Revenue Service (the "Service" or "IRS") and are often not fully understood by conduit issuers. Conduit issuers have an unusual status under the Internal Revenue Code: they are generally not subject to federal income tax and are generally not the real obligors of the debt that they issue, but they are treated as "taxpayers" for many procedural purposes.

This report describes in detail the responsibilities of conduit issuers under current federal income tax rules, describes the range of different policy approaches that conduit issuers may choose to take to fulfill an oversight function, and makes recommendations to the Service relating to its relationship with conduit issuers.

In effect, the role of the conduit issuer set forth in the Code represents an application of federalism: it is a mechanism under which the federal government has in effect delegated to state and local governments the responsibility for administering tax benefits. Many of the recommendations in this report are made in light of the principles of federalism that appear to be inherent in the structure of the Code that pertain to conduit issuers.

The ACT recommends that the Service should develop a more comprehensive framework defining the role of conduit issuers in a manner that reasonably fosters tax administration but does not unnecessarily entail procedural and administrative costs for conduit issuers, conduit borrowers, and the Service. In particular, the ACT believes that certain of the administrative procedures relating to conduit issues unnecessarily require full participation of conduit issuers where no significant tax administration benefit is served. On the other hand, the ACT recommends that in other respects the Service should consider inviting or enlisting conduit issuers to play a more meaningful role in tax administration. The ACT recommends that the Service should prepare and release a publication more clearly defining the oversight role of conduit issuers, and that the Service should engage conduit issuers in a more structured dialogue regarding the oversight role of conduit issuers in tax compliance.

Introduction

Tax-exempt bonds and tax credit bonds are required to be issued by a State or local government, even in cases where the real obligor and beneficiary of the financing is permitted to be an entity other than a State or local government. In addition, certain State or local government bonds are issued for the purpose of making loans to other local governments. Tax-exempt bonds and tax credit bonds that are issued for the purpose of making loans to other entities are referred to as "conduit issues," and the State or local governments that issue such bonds are referred to as "conduit issuers." This report considers the role of conduit issuers in federal income tax compliance in connection with such issues.

Recent legislation expanded the types of tax-advantaged "conduit issue bonds," including various tax credit bonds issued under the provisions of the American Recovery and Reinvestment Act of 2009 and the Hiring Incentives and Restore Employment Act of 2010.

1. Background

a. *Original published rulings and regulations.*

The Service appears to have first recognized a conduit issuer as an issuer of tax-exempt bonds in Rev. Rul. 57-187. In that revenue ruling, an Industrial Development Board formed by a municipality was held to be a local government issuer for purposes of section 103 of the Internal Revenue Code of 1954, even though bonds issued by the Board were payable only from revenues derived from the sale or lease of financed projects. The Service subsequently held that certain "on behalf of" issuers could be treated as state or local government issuers of tax-exempt bonds in Rev. Rul. 63-20.

Notwithstanding the issuance of revenue rulings respecting conduit issues as state or local government obligations, the IRS soon thereafter began to question the basis for respecting conduit issues for the benefit of nongovernmental persons (so-called "industrial development bonds") as state or local government obligations. In TIR-80, issued August 11, 1966, the IRS announced that it would decline to issue rulings regarding whether industrial development bonds qualified under section 103(a) of the Internal Revenue Code of 1954.[1]

On July 24, 1967, Representative John Byrnes introduced H.R. 11645 which would have amended section 103 to exclude from the exemption any future issues of industrial development bonds, stating as follows:

[1] A lengthy discussion of the history of the Service's treatment of conduit issues prior to 1972 is set forth in *Fairfax County Economic Development Authority v. Commissioner*, 77 T.C. 546 (1981). Parts of this background discussion repeat the discussion in that opinion.

> The exemption privilege . . . was never intended as a means whereby private corporations could borrow money at low interest rates using the governmental unit as an "umbrella". . . . This practice . . . makes a mockery of our tax laws. The tax-exempt status of interest on municipal bonds must be limited to legitimate governmental functions where it is the credit of the municipality that supports the bond not the credit of some second party beneficiary. 113 Cong. Rec. 19877 (July 24, 1967).

On November 8, 1967, Senator Abraham Ribicoff introduced companion bills to prohibit industrial development bonds and arbitrage bonds. He stated that industrial development bonds "are truly corporate bonds and the local government's involvement is often little more than a sham." 113 Cong. Rec. 31612 (1967). Senator Ribicoff noted the inconsistency in the position of the IRS of permitting industrial development bonds but effectively prohibiting arbitrage bonds, because in both instances the locality acts as a mere conduit for the interest paid by the "real obligor."

In TIR-972, issued on March 6, 1966, one week before Senate hearings on industrial development bonds, the Service announced that is was reexamining its position that industrial development bonds would be considered obligations within the meaning of section 103(a). The Service published proposed regulations on March 23, 1968, providing that interest paid on industrial development bonds were not "obligations of a State . . . or any political subdivision" within section 103(a), because the primary obligor was not a State or political subdivision. 33 Fed. Reg. 4950 (1968).

Following a debate over whether the Service's prior position should be reversed by administrative or legislative action, the Senate adopted provisions suspending the proposed regulations and prospectively limiting the use of industrial development bonds. See Conf. Rept. 1533, 90th Cong., 2d Sess., (1968), 1968-2 C.B. 801, 806. The Conference Committee reworked the Senate provisions, and Congress adopted the Conference substitute, which "for the future provided exclusive rules for industrial development bonds . . . within the definition contained in the [statute] specifying the types of bonds which in the future are to be taxable and the types of such bonds which are to be tax exempt." Conf. Rept. 1533, *supra*, 1968 C.B. at 806.

The industrial development bond provision, in the Revenue and Expenditure Control Act of 1968, contained specific exemptions for facilities which Congress considered to be legitimate functions of local governments, as well as a very narrow small issue exemption. Congress did not in any manner discuss the procedural or tax compliance role of conduit issuers in this seminal legislation.

In *Fairfax County Economic Development Authority v. Commissioner*, the Tax Court reviewed this administrative and legislative history, and concluded that Congress clearly intended that the "real obligor" rule did not apply to tax-exempt conduit bonds, but only for the limited purpose of determining compliance with section 103:

> The logical inference drawn from the history of section 103(b) is that while Congress was aware of the true nature of IDBs, i.e., the identity of the "real

> obligor" . . . , it was determined in its wisdom that IDBs would be tax exempt under specified conditions. Thus, Congress rejected [the Service's] wholesale position, set forth in 1968 . . . proposed regulations and the congressional hearings . . ., that the municipal veil should be pierced on the basis that the State or local government issuing a debt instrument is not the "real obligor." Instead, Congress adopted a modified "real obligor" theory and excluded certain IDBs only to the extent that the proceeds did not inure to what it perceived to be appropriate public purposes, i.e., the exempt activities set forth in [the statute]. . . . Thus, in our judgment, by having dealt in detail with the tax status of IDBs, Congress preempted the field and effectively precluded any general adoption of the "real obligor" theory as a judicial gloss on section 103 – at least insofar as the tax consequences of IDBs, as defined in the statute, are concerned.[2]

Inherent in the statutory approach adopted by Congress was a tension, and a potential set of ambiguities, regarding when the conduit issuer (as the nominal issuer) would be treated as the issuer of the bonds and when the conduit borrower (as the real obligor) would be treated as the issuer of the bonds for different purposes. This tension and ambiguity was considered in a series of revenue rulings published by the Service after 1968, which generally adopted the view that the conduit borrower, as the real obligor, should be treated as the issuer of conduit bonds for all purposes other than as necessary under the tax-exempt bond eligibility rules.

Shortly after the enactment of the 1968 Act, the Service published Rev. Rul. 68-590[3], which considered a situation in which a political subdivision issued tax-exempt bonds and used the proceeds to acquire a facility which it leased, with an option to purchase, to a nonexempt person. The transaction was structured so that the political subdivision had no risk of loss and no opportunity to gain from the transaction. The Service ruled that the nonexempt person must take into account any premium or discount on the bonds under section 61 of the Code and was entitled to interest deduction under section 163 of the Code for the portion of its lease payments that represented interest on the bonds. The Service also ruled that the lessee was treated as the owner of the financed property for federal income tax purposes, including depreciation deductions, investment tax credit and other deductions.

In Rev. Rul. 77-262[4], a county issued bonds to finance the construction and equipping of a manufacturing facility, which it leased to a nonexempt person in a manner similar to Rev.

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[2] 77 T.C. 546, 555 (1981). *Fairfax County* considered whether a local government bond issued to make a lease to the U.S. Government Printing Office could qualify as a "small issue" industrial development bond. The Tax Court held that the federal government was not the issuer of the bonds for purposes of qualification with the "small issue" industrial development bond requirements, but held that the bonds did not qualify as tax exempt on other grounds.

[3] 1968-2 C.B. 66.

[4] 1977-2 C.B 41.

Rul. 68-590. The Service ruled that the interest accruing to the bondholders (and not just the interest accruing to the conduit issuer) on that portion of the bond proceeds allocable to the construction of the facility may be capitalized by the nonexempt person under Section 266 of the Code up to the time the construction of the facility was completed.

In Rev. Rul. 81-281[5], the Service held that interest on an issue of tax-exempt conduit bonds is not excludible from gross income after the term of the underlying security and the terms of the bonds are substantially altered without action by the conduit issuer.

b. *Subsequent changes to the Internal Revenue Code relating to conduit bonds.*

Subsequent to 1968, Congress amended the provisions of the Internal Revenue Code of 1954 relevant to conduit issues, generally to restrict the permitted purposes for tax-exempt conduit issues. The legislative history to these amendments does not discuss the intended tax compliance role of conduit issuers. For the purposes of this discussion, the most important amendments were the addition in the Tax Equity and Fiscal Responsibility Act of 1982 of the requirement that all "industrial development bonds" be approved by a State or local government, and the addition in the Deficit Reduction Act of 1984 that most "industrial development bonds" be subject to a volume cap limitation administered by State or local governments. These amendments do not describe the intended compliance role of conduit issuers in detail, but do evidence a general intent that the tax subsidy represented by tax-exempt conduit bonds be administered by State or local governments. For example, the Senate Report to the Tax Equity and Fiscal Responsibility Act of 1982 states as follows:

> . . . the committee believes that, in general, State and local governments are best suited to determine the appropriate uses of IDBs. The committee believes that providing tax exemption for the interest on certain IDBs may serve legitimate purposes in some instances provided that the elected representatives of the State or local government unit determine after public input that there will be substantial public benefit from the issuance of obligations and provided that the affected public has had an opportunity to comment on the use of tax-exempt financing for particular facilities.[6]

The Internal Revenue Code of 1986 substantially revised the permitted purposes and other restrictions that apply to conduit issues, but carried forward the basic structure of permitting conduit issues for certain identified purposes (generally referred to as "qualified private activity bonds").

c. *Development of IRS enforcement program treating the issuer as the taxpayer.*

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[5] 1981-2 C.B. 18.

[6] S. REP. NO. 97-497, at 168 (1982).

Before 1993, the Service had no organized comprehensive program for tax-exempt bond enforcement. The Service had entered into approximately 70 closing agreements with tax-exempt bond issuers before 1993 to resolve disputes. In many of these cases, however, issuers voluntarily submitted requests to the Service after release of published rulings by the Service, and not as a result of an active enforcement program.

In 1993, the General Accounting Office (GAO) published a report that was sharply critical of the failure of IRS to monitor tax-exempt bond compliance in a systematic way. See *General Accounting Office Report on "Improvements for More Effective Tax-Exempt Bond Oversight*," GAO/GGD-93-014, dated May 10, 1993. The GAO report encouraged a more proactive approach. The GAO Report recommended, among other things, that the Service should "develop and implement a plan to guide efforts throughout the IRS to make more effective use of resources to promote voluntary compliance in the tax-exempt bond industry." Largely in response to the GAO report, the IRS announced the formation of a new tax-exempt bond compliance program in 1993 ("Tax Exempt Bond Program"). See Announcement 93-92, 1993-24 I.R.B. 1. This Announcement was released in conjunction with the release of final regulations in 1993 concerning the "arbitrage and rebate" investment restrictions on tax-exempt bonds. The 1993 regulations notably included a detailed rule outlining the role of conduit issuers, as is further discussed below.

Many of the most difficult procedural issues raised by the new Tax Exempt Bond Program concerned the taxpayer confidentiality rules of section 6103 of the Code. The disclosure litigation attorneys within the IRS Office of Chief Counsel played an important role in the development of IRS procedures in this area.

In 1995, the IRS addressed disclosure concerns raised by the new Tax Exempt Bond Program in Disclosure Litigation Bulletin 95-2. This bulletin stated that information received or collected by the IRS during the examination of a tax-exempt bond issue, including the identity of the issuer, is return information prohibited from disclosure by section 6103(a) of the Code and that disclosures of such information to persons other than the issuer or bondholders should be approached like any other third-party disclosure of information. The bulletin further indicated that, as an example, consent of the issuer (Form 8821) should be obtained before permitting the conduit borrower to participate in the bond examination or in a request for technical advice during the bond examination.

The disclosure litigation attorneys in the IRS Office of Chief Counsel also prepared a detailed "*Disclosure Guide for Tax-Exempt Bond Examinations*" (the "Disclosure Guide"). The Disclosure Guide discusses the technical basis for the IRS position that a tax-exempt bond issuer is a "taxpayer" for disclosure purposes and addresses a number of practical questions that arise in an examination. In particular, the Disclosure Guide discusses the extent to which a conduit borrower may be informed of an examination of a bond issue and the extent to which a government issuer may be informed of an examination of the conduit borrower. The Disclosure Guide generally takes the position that the IRS is not authorized to openly discuss bond issues with the conduit borrower, unless the conduit borrower obtains a disclosure waiver from the issuer.

There is little case law authority considering the role of conduit issuers in tax compliance, but perhaps the most significant decision to arise out of the Service's tax-exempt bond compliance program does address this role. See *Harbor Bancorp v. Commissioner.*[7] That decision concerned a conduit issue issued by the Housing Authority of Riverside County for the stated purpose of financing multifamily housing. The Service asserted, among other things, that there was no reasonable expectation that the housing project would be actually constructed, and that the bonds were in substance issued only to make an investment profit. The County of Riverside asserted that it was deceived by the conduit borrower, and that it did not have responsibility for the improper uses of the bond proceeds. The majority opinion of the Tax Court summarized its view of the responsibilities of the conduit issuer as follows:

> One might also sympathize with the situation of the Housing Authority of Riverside County. However, it seems clear that, as between it and the Federal Government, the Housing Authority should bear responsibility for what happened. The Housing Authority issued the Bonds and selected those who were responsible for implementing their issuance and applying the proceeds. Congress clearly wanted issuers to be responsible for meeting the requirements for tax exemption. The Housing Authority certified that the Bonds would qualify for tax exemption. Like any other local government bond issuer, the Housing Authority was responsible for paying any amount required by section 148(f)(2) [that is, the rebate requirement], regardless of whether it intended to generate [investment profits] . . . It has thus far chosen not to do so. Unfortunately for the bondholders, the statutorily required result of this choice is that interest on the Bonds is not exempt from Federal taxation.[8]

The affirming opinion of the Ninth Circuit in *Harbor Bancorp* did not include as extensive a discussion of the responsibilities of the conduit issuer, but did hold that the bonds were arbitrage bonds regardless of whether the conduit issuer directly controlled the investments of bond proceeds. Taken as a whole, *Harbor Bancorp* stands for the principle that conduit issuers have responsibility for compliance with tax-exempt bond requirements, but the exact extent of that responsibility is not defined in the decisions.

The IRS Restructuring and Reform Act of 1998, for the first time, specified in legislation the rights of a tax-exempt bond "issuer" in IRS enforcement proceedings:

> The Internal Revenue Service shall amend its administrative procedures to provide that if, upon examination, the Internal Revenue Procedure proposes to an issuer that interest on previously issued obligations of such issuer is not excludable from gross income under section 103(a) of the Internal Revenue Code of 1986, the issuer of such obligations shall have an administrative

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[7] 105 T.C. 260 (1995), aff'd, 115 F.3d 1997 (9th Cir. 1997).

[8] 105 T.C. at 287-288.

appeal of right to a senior officer of the Internal Revenue Service Office of Appeals.[9]

This provision did not expressly indicate whether an "issuer" for this purpose necessarily referred to a conduit issuer, or could also refer to a conduit obligor.

It appears that the Service has not revisited the disclosure approach after enactment of this legislation, or other developments subsequent to 1995.

2. The required roles of conduit issuers

The required roles of conduit issuers are set forth in a variety of provisions in the Code, income tax regulations, published rulings, and the Internal Revenue Manual. These provisions do not generally require a conduit issuer to monitor or assure compliance with all federal income tax eligibility requirements that apply to a bond issue, but do require a conduit issuer to take a number of specific actions.

Requirements set forth in the Internal Revenue Code

The Code expressly sets forth only a few required roles for conduit issuers:

a. *Act as nominal issuer.*

Sections 103(a) and 103(c) of the Code require that a tax-exempt bond must be an "obligation of a state or political subdivision thereof."

b. *Allocation, monitoring and carryforward of volume cap.*

Under section 146 of the Code, most types of qualified private activity bonds are subject to a volume cap. A volume cap allocation is separately made to each State. Section 146(e) provides that a State may, by law, provide for a different formula for allocating State ceiling among the governmental units (or other authorities) in the State having authority to issue tax-exempt private activity bonds. Section 146(f) generally provides that an issuing authority may carry forward unused volume cap to subsequent years. Section 149(e) generally requires that an information return must be filed in connection with the issuance of tax-exempt bonds, which must include "a certification by a State official designated by State law . . . that the bond meets the requirements of section 146 (relating to cap on private activity bonds), if applicable." Section 146 accordingly implies an obligation to monitor volume cap allocations, but does not set forth any procedures or requirements for monitoring, other than procedures for filing information returns and making carryforward elections.

[9] Section 3105 of the IRS Restructuring and Reform Act of 1998.

c. *Public approval.*

Section 147(f) of the Code generally requires that an issue of qualified private activity bonds must be approved by the governmental unit which issued such bonds or on behalf of which the bonds were issued and each governmental unit having jurisdiction over the area in which any facility, with respect to which financing is provided from the net proceeds of the issue, is located. If more than one governmental unit within a State has jurisdiction over the entire area within the State in which the facility is located, only one such unit needs to approve the bond issue. The bond issue must be approved by the applicable elected representative of such governmental unit after a public hearing following reasonable public notice or by voter referendum of the governmental unit.

Requirements set forth in regulations

The most comprehensive statement defining the role of conduit issuers set forth in published guidance is contained in the definition of "issuer" set forth in the arbitrage regulations under section 148:

> *Issuer* generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.[10]

For purposes of the arbitrage restrictions, this definition applies to all tax-exempt bonds, including all qualified private activity bonds. This definition is incorporated by reference in the private activity bond regulations that apply for purposes of sections 141 and 145 of the Code.[11] Accordingly, this definition expressly applies for purposes of the use-of-proceeds rules that apply to qualified 501(c)(3) bonds. This definition does not expressly apply to the use-of-proceeds rules or other rules that apply to other types of qualified private activity bonds, although an argument can be made that it should apply by analogy for all tax-exempt bond purposes.

d. *Elections.*

The arbitrage regulations set forth the following general rule for making elections:

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[10] Treas. Reg. §1.148-1(b).

[11] Treas. Reg. §1.141-1(a).

> Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.[12]

The private activity bond regulations set forth the following comparable rule for elections:

> Elections must be made in writing on or before the issue date and retained as part of the bond documents, and, once made, may not be revoked without the permission of the Commissioner.[13]

The following elections, if made, must be made by a conduit issuer under these regulations:

> *i. Election to waive the right to treat a purpose investment as a program investment.*[14]
>
> *ii. Election to waive the right to invest in higher yielding investments during any temporary period.*[15]
>
> *iii. Election of the issuer of a pooled financing issue to apply rebate spending exceptions separately to each conduit loan.*[16]
>
> *iv. Election for purposes of the two-year spending exception from rebate to apply certain provisions based on actual facts rather than reasonable expectations.*[17]
>
> *v. Election for purposes of the two-year spending exception from rebate to exclude from available construction proceeds the earnings on a reasonably required reserve or replacement fund.*[18]
>
> *vi. Election for purposes of the two-year spending exception to treat a portion of an issue as a separate construction issue from rebate.*[19]
>
> *vii. Election to pay one and one-half percent penalty in lieu of arbitrage rebate.*[20]

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[12] Treas. Reg. §1.148-1(d).

[13] Treas. Reg. §1.141-1(c).

[14] Treas. Reg. §1.141-1(b).

[15] Treas. Reg. §1.148-2(h).

[16] Treas. Reg. §1.148-7(b)(6).

[17] Treas. Reg. §1.148-7(f)(2).

[18] Treas. Reg. §1.148-7(i)(2).

[19] Treas. Reg. §1.148-7(j).

viii. Election to treat portions of a bond issue as separate issues.[21]

The regulations do not, however, require that all choices made regarding computation of rebate need to be made by the conduit issuer. For example, there is no requirement that the selection of a "bond year" for purposes of rebate computations must be made by the conduit issuer, because the choice of bond year is not characterized as a formal election under the regulations.

e. *Qualified hedge identifications.*

The arbitrage regulations permit certain interest rate hedges, such as interest rate swaps, to be taken into account in determining the yield on a bond issue. The regulations provide that one of the requirements is that the conduit issuer "identify" the interest rate hedge within 3 days of the date the hedge is entered into.

f. *Filings.*

i. Form 8038 and Form 8038-G

ii. Form 8038-T

iii. Form 8038-R

iv. Supplemental Form 8038 in connection with a remedial action

v. Notice of defeasance in connection with a remedial action

g. *Liability for rebate.*

As a technical matter, neither the conduit issuer nor the conduit borrower is liable for rebate payments, in the sense that the Service may not take collection actions against either. However, if rebate is not timely paid in the correct amount, the bonds may not qualify as tax exempt. Responsibility for the actual payment is generally set forth by contract between the parties. Generally the conduit borrower agrees to provide the funds for the payment. However, the payment must directly be provided by the conduit issuer and the Form 8038-T accompanying the payment must be signed by the conduit issuer, not by the conduit borrower. The tax identification number of the conduit issuer is used to track the payment.

h. *Certification regarding expectations for arbitrage purposes.*

The arbitrage regulations generally require a conduit issuer to make a certification regarding its expectations in the following manner:

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[20] Treas. Reg. §1.148-7(k) and section 148(f)(4)(C)(vii) of the Code.

[21] Treas. Reg. §1.150-1(c)(3).

An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's reasonable expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.[22]

This certification is not required if the issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund or the issue price of the bond issue does not exceed $1,000,000.

i. *Reimbursement declarations of intent.*

Under regulations that generally apply to tax-exempt bonds and tax credit bonds, an issuer or conduit borrower is permitted to use bond proceeds to reimburse certain expenditures paid before the date of issuance subject to certain requirements. One requirement is that the issuer must adopt a declaration of intent to reimburse expenditures not later than 60 days after the reimbursed expenditure is paid. In the case of qualified 501(c)(3) bonds only, a conduit borrower may adopt a declaration of intent. Accordingly, for most types of qualified private activity bonds (and tax credit bonds that have requirements similar to qualified private activity bonds) the conduit issuer must act to adopt declarations of intent to permit reimbursement financing.

j. *Limitations on issuer fees*.

Section 148(a)(1) of the Code limits the yield permitted on investments related to tax-exempt obligations. Among the investments so limited in yield are "purpose investments" defined in Treas. Reg. § 1.148-1. Although the primary underlying purpose of the arbitrage provisions of the Code (prevention of the overburdening of the market in tax-exempt bonds though the early issuance, over-issuance, or late maturity of the bonds) is not directly furthered by the application of restrictions to purpose investments, those provisions apply to purpose investments. In typical private activity conduit bond issues, the proceeds of the bonds are lent to a private person (for example, a 501(c)(3) organization) that uses the proceeds. The loan of the proceeds to the private person is the purpose investment.

Generally, the limitations on the yield of the purpose investment (conduit loan) to no more than a spread over the bond yield is a limitation on the fees that the issuer may collect from the conduit borrower. There are two broad categories of purpose investments: 1) "program investments," and 2) purpose investments that are not "program investments." Program investments are purpose investments that are part of a program of making loans of a particular type, often to a broad range of conduit borrowers. Program investments are

[22] Treas. Reg. §1.148-2(b)(2)(i).

limited to housing purposes, loans to 501(c)(3) organizations, loans to governmental persons, or loans to a large class of people (*e.g.* student loan bonds). The "spread" permitted for program investments is 1.5%.[23] For other purposes, the "permitted spread" is generally 0.125%. Certain costs paid by the issuer are "qualified administrative costs" that can be used to offset receipts by the issuer under a purpose investment. Reasonable costs of issuance, for example, may be paid by the conduit borrower without arbitrage consequences to the yield on the purpose investment. The class of costs getting such favorable treatment is narrower for program investments than for other purpose investments. In all conduit transactions (unless the conduit loan is itself tax-exempt), the issuer must make sure that the amount collected from the conduit borrower in excess of principal of and interest on the tax-exempt bond does not exceed the arbitrage limits (with the appropriate adjustments for costs paid).

Conduit issuers have a large variety of policies regarding issuer fees. Some conduit issuers charge nothing, or only ask for reimbursement of their out-of-pocket costs for hiring counsel or advisors related to the bond issue. Others charge up-front initial fees, ongoing periodic fees (*e.g.* annual fees) and application fees (in addition to or instead of reimbursement for out-of-pocket expenses). These fees may divert some of the benefit of tax-exempt financing from the conduit borrower to the issuer, either to cover its own costs, or to provide an income stream for other (possibly unrelated) functions of the issuer. In the past, some issuers imposed fees intended to maximize income to the issuer (at the expense of the conduit borrower) within the arbitrage limits. More recently most issuers have kept fees to reasonable levels related to the conduit issuer function (perhaps using fees from some borrowers to subsidize other borrowers). None of the issuers we surveyed attempted to maximize their profits within the arbitrage limitations. This may, in part, be due to increased competition. Conduit borrowers often have multiple potential issuers from which to choose.

Requirements set forth in published rulings

k. *Providing authorization or other approval when a significant modification of outstanding bonds results in a "reissuance."*

Rev. Rul. 81-281 provides that, if a conduit borrower and bondholders agree to a modification of outstanding bonds that is treated as an exchange of the outstanding bonds for new modified bonds (that is, is treated as a "reissuance"), the conduit issuer must authorize or take other action to approve the new modified bonds.

l. *Requesting private letter rulings.*

Revenue Procedure 96-16 sets forth required procedures under which an issuer of tax-exempt bonds can request a private letter ruling. Separate procedures apply to

[23] Student loan obligations and single family mortgage obligations are subject to special rules with different spreads.

"reviewable" private letter ruling requests under section 7478 of the Code and to "nonreviewable" private letter ruling requests. Under section 7478 of the Code, an issuer may appeal the denial of a private letter ruling to the United States Tax Court. The revenue procedure generally requires that, in the case of the conduit issue, the private letter ruling request must be submitted by the conduit issuer, rather than the conduit borrower.[24]

m. *Requesting voluntary closing agreements.*

Internal Revenue Service Notice 2008-31 provides information about the voluntary closing agreement program for tax-exempt bonds and tax credit bonds. This notice, and the Internal Revenue Manual provisions referenced by the notice, generally contemplate that the conduit issuer must request and execute a voluntary closing agreement.

Requirements set forth in the Internal Revenue Manual

The IRS has released detailed tax-exempt bond administrative procedures under section 4.81.1 of the Internal Revenue Manual. These administrative procedures generally define the "issuer" as "the state or political subdivision or entity that issues bonds on behalf of a state or local government."

n. *Acting as the "taxpayer" in tax-exempt bond examinations.*

The tax-exempt bond administrative procedures provide that the conduit issuer, and not the conduit borrower, will be treated as the "taxpayer" in Internal Revenue Service examinations of tax-exempt bonds. This means that the conduit issuer will receive the letters initiating the examination and need to be a party to any closing agreement resolving the examination.

3. Survey of the Current Practices of Conduit Issuers

a. *Responses to issuer survey and outreach*

The ACT published a list of questions, reproduced in Appendix A, which asked state or local government issuers to provide their experiences and procedures in acting as a conduit issuer for tax-exempt bonds. This list of questions was distributed to members of the National Association of Health and Educational Facilities Financing Authorities and the National Council of State Housing Agencies. Summaries of the responses to each question are provided below. In addition, the ACT reached out to industry and practitioner groups listed in Appendix A for further input and comment.

[24] Rev. Proc. 96-16 also contemplates that a bondholder may submit a nonreviewable request for a private letter ruling. The wording of section 7478 of the Code does not expressly require that a reviewable request must be submitted by a conduit issuer.

b. *Types of respondents*

Issuers of conduit bonds fall into many categories. These include operating entities such as cities, as well as special purpose entities that serve no purpose other than as a bond issuer. Our survey asked various questions about the nature of the respondents. The purpose of these questions was not to determine the percentage of issuers that fell into each of these categories, but rather to allow the other responses to be interpreted fairly. For example, there are many issuers with virtually no staff, no permanent offices and no activity except when requested to act by a conduit borrower. Our survey appears not to have reached this class of issuers. The issuers surveyed fell into the following categories:

Operating entity – 67%

Full time Staff – 92%

Other respondents had part time staff.

Respondents varied on the types of issues they issued. Types of issues included governmental bonds, qualified 501(c)(3) bonds, and private activity bonds (non-qualified 501(c)(3)). Few of the respondents issued over 50 conduit bond issues, but a majority issued over 10. Qualified 501(c)(3) issues appeared to be the biggest category of bonds issued by the respondents. The respondents were relatively large issuers. 70% of the respondents issued over $500,000,000 of conduit bonds for 501(c)(3) borrowers. None issued under $5,000,000 in any category (unless they issued none in that category).

c. *Internal review process*

A vast majority of respondents did have in place review processes to determine if bond issues met the tax-exempt bond law requirements. Our conclusion is that at least our respondents take their role as conduit issuer very seriously and devote resources to assuring that tax law requirements are met. The respondents also had procedures relating to the financial wherewithal to repay the bonds. Although post-issuance compliance was important to most responding issuers, a majority of respondents did not require preliminary opinions of counsel prior to the date of issuance.

d. *Types of compliance procedures*

The responding issuers appeared to require comprehensive procedures covering all of the core elements of compliance addressed in the survey, including arbitrage rebate, expenditure of funds, private use (where applicable), economic life of financed property and unspecified other matters.

e. *Issuer staff involvement with post issuance procedures*

Survey respondents overwhelmingly indicated that they do have dedicated staff assigned to monitor post issuance compliance. The experience of ACT members indicates that the respondents may not be representative of all issuers in this respect. However, the prevailing policy of larger bond issuers appears to have staff assigned to this task. The

survey did not ask the extent of involvement of these issuer personnel. Undoubtedly many of these staff passively accept periodic reports of the conduit borrower and are available to provide assistance should it be required. It is not our sense that these issuer staff generally take over the responsibilities of the conduit borrower.

f. *Standard documentation*

Over 90% of the respondents indicated that they policed the documentation of bond issues and required specific language to be included in the bond documents related to tax compliance. This seems to fit with other responses concerning required reporting to the issuer, which is obviously easier with standard documentation.

g. *Investment control*

Most of the respondents indicated that investment decisions were treated as the responsibility of the conduit borrowers, not the conduit issuer. This matches the experience of the ACT members and also reflects the recognition that in most conduit transactions the investments are treated as property of the conduit borrowers. However, a significant minority indicated that either the conduit issuer controlled the investment, or that a party hired by the conduit issuer controlled the investment. Thus, a significant number of conduit issuers appear to consider investment of bond proceeds as a function meriting conduit issuer control. Over 90% of the respondents indicated that proceeds were held by a bond trustee prior to expenditure. Bond trustees usually do not, however, have independent discretion over the investment of funds they hold.

h. *Periodic compliance reporting*

Generally, respondents indicated that they do require annual reporting concerning a variety of post-issuance tax compliance items. Such reports were usually required to be furnished to both the conduit issuer and a bond trustee (and sometimes to other parties as well). Some required semiannual reporting. None required reporting less frequently than annually. Where the reports were required to be given to the bond trustee or another party, only about 10% of the respondents required that other party to determine if the report adequately supported ongoing tax exemption. The reporting conduit borrowers continue to have the principal responsibility for ongoing compliance. The scope of the required reporting appeared to generally be quite comprehensive, including arbitrage, private use, and other matters. However, only half of the respondents specifically required separate arbitrage rebate or private use reporting. The other respondents appeared to rely on reporting of general compliance.

i. *IRS examination response procedures*

Perhaps surprisingly, less than half the respondents had specific required procedures for responding to an IRS examination of bonds. This may be because the respondents have not yet had sufficient experience to form the basis for such policies. We also note that the lack of formal procedures does not mean that the conduit issuer will respond inappropriately should its bonds be examined. Even though a majority of the respondents reported not having a general policy about responding to examinations, over two-thirds

required that the conduit borrower pay the costs of responding to the examination. A quarter of the respondents stated that they split the cost with the conduit borrower and a significant minority indicated that the issuer would pay the costs. Regardless of who is required to pay the costs, a large majority of respondents indicated that in any examination the conduit issuer would retain counsel. There are perhaps many reasons for this including the requirements under current Internal Revenue Manual procedures that treat the conduit issuer as the taxpayer in an examination.

j. *Voluntary resolution procedures*

Most of the responding conduit issuers did not have procedures in place for dealing with applications for relief under the TEB voluntary closing agreement program. Because current Internal Revenue Manual procedures require that the request come from the conduit issuer, this may seem surprising. It also suggests that there exists a general need to educate conduit issuers about the TEB voluntary resolution program. The result may also indicate that maybe the Service should consider the conduit borrower as the one to handle voluntary closing agreement requests with minimal or no conduit issuer involvement.

k. *Recordkeeping*

A minority of respondents considered themselves as keepers of comprehensive records. However, only a third of respondents indicated that they did not keep records at all. The types of records kept by the conduit issuer respondents was varied, with less than 10% keeping expenditure records, private use records, or remedial action records. Less than 20% kept investment records. Evidently the responding conduit issuers considered recordkeeping to be primarily the responsibilities of the conduit borrowers. Of those who stated that they kept records, a large majority were committed to keeping records for at least three years after the payment in full of the bond issue. Many kept records for considerably longer periods.

l. *Extrajurisdictional bond issues*

Most respondents indicated that they do not act as conduit issuers for financing facilities outside of their geographic jurisdiction and do not act as the “host” jurisdiction for facilities located in their jurisdiction for other conduit issuers. However 100% of the respondents who did participate in either role indicated that the two entities involved cooperated with each other.

m. *Fees*

Almost all responding issuers said that they charged fees to act as issuer. Most of these fees were based on a percentage of the bond issue size.

4. Discussion

Conduit issuers are important stakeholders and participants in the issuance of tax-exempt bonds and tax credit bonds, and the administration of the federal income tax eligibility

requirements relating to those bonds, but the appropriate roles of conduit issuers have not been systematically considered by the Service and the community of conduit issuers.

In the case of all qualified private activity bonds and non-governmental tax credit bonds, a state or local government is required by the Code to participate in the financing as a conduit issuer in order for the bonds to qualify for tax-advantaged status. In certain respects, this required role may be viewed as an historical artifact of the longstanding treatment of state and local bonds as tax-exempt obligations.

Congress has specifically and consistently chosen, however, to continue the requirement of state and local government conduit issuer involvement, even though other approaches to the same types of tax-advantaged financings could be administratively simpler. For example, Congress could have simply permitted 501(c)(3) organizations to directly issue tax-exempt obligations, without the requirement of any conduit issuer involvement. Similarly, Congress could have permitted conduit borrowers of other types of qualified private activity bonds or tax credit bonds to directly issue those bonds, after receiving a volume cap allocation from the appropriate state or local government allocating entity.

The legislative continuation of the requirement of a state or local government conduit issuer reasonably implies that Congress intended that conduit issuers play an important role in tax-administration or policy, even though the legislative history does not discuss in any detail what that role should be. The possible tax administration benefits of the requirement include increased public transparency of the administration of the tax subsidy and a second level of governmental review and monitoring of tax compliance. In effect, the role of the conduit issuer set forth in the Code represents an application of federalism: it is a mechanism under which the federal government has in effect delegated to state and local governments the responsibility for administering tax benefits. Many of the recommendations in this report are made in light of the principles of federalism that appear to be inherent in the structure of the Code that pertain to conduit issuers.

Published guidance, particularly since the publication of final regulations under section 148 dealing with “arbitrage” in 1993, has generally reflected a policy view on the part of the Service and the Department of the Treasury that it is important for conduits issuers to play at least some role in tax administration, although the Service has not articulated a comprehensive framework of what that role is or should be. Perhaps the most significant published guidance statement of the role of conduit issuers is set forth in the 1993 regulations. Those regulations generally take the view that with respect to provisions relating to direct interaction with the Service (such as making filings and formal tax elections) conduit issuers appropriately should play a role.

The ACT recommends that the Service should develop a more comprehensive framework defining the role of conduit issuers in a manner that reasonably fosters tax administration but does not unnecessarily entail procedural and administrative costs for conduit issuers, conduit borrowers, and the Service. In particular, the ACT believes that certain of the administrative procedures relating to conduit issues unnecessarily require full participation of conduit issuers where no significant tax administration benefit is served. Examples include the requirement that a conduit issuer must generally submit a voluntary closing

agreement to resolve post-issuance noncompliance and the Service's procedural stance that only a conduit issuer is a "taxpayer" under section 6103 with respect to tax-exempt bond and tax credit bond matters.

On the other hand, the ACT recommends that in other respects the Service should consider inviting or enlisting conduit issuers to play a more meaningful role in tax administration. In particular, in recent years the Service has emphasized in many initiatives the importance of post-issuance compliance relating to tax-exempt bonds and tax credit bonds. The Service has not, however, opened a dialogue with conduit issuers in a systematic manner regarding the role of conduit issuers in post-issuance compliance.

5. The Internal Revenue Service position treating conduit issuers as "taxpayers" for purposes of taxpayer confidentiality rules

The Service has for many years treated conduit issuers, rather than conduit borrowers, as "taxpayers" for purposes of section 6103 in relation to tax-exempt bond compliance matters, even though conduit issuers have no direct income tax liability.

Before the enactment of the IRS Restructuring and Reform Act of 1998, this position is understood to have been primarily based on the following considerations: (1) conduit issuers are generally required to file Form 8038 information returns; (2) one of the conditions for tax exemption is the payment of rebate which, although not a tax, is in some respects similar to payment of a tax; and (3) state and local governments are afforded special rights to seek declaratory judgment in Tax Court in the event that the Service declines to rule favorably on a private letter ruling request relating to the qualification of state or local government obligations as tax-exempt bonds.

The enactment of Section 3105 of the IRS Restructuring and Reform Act of 1998 in effect affirmed the prior position of the Service that tax-exempt bond issuers are appropriately treated as "taxpayers" for purposes of the confidentiality restrictions of section 6103. The provision's direction that, if upon examination the Service proposes to tax interest on obligations that purport to be tax-exempt bonds, "the issuer of such obligation shall have an administrative appeal right" necessarily implies that conduit issuers of tax-exempt bonds should generally be treated as "taxpayers" for purposes of section 6103 and other procedural purposes.

The Service has not generally treated conduit borrowers as "taxpayers" for purposes of section 6103, although the basis for doing so would appear to be at least as sound as the basis for treating conduit issuers as taxpayers. The reference to the "issuer" of obligations having appeal rights in section 3105 of the IRS Restructuring and Reform Act of 1998 can reasonably be interpreted to apply to a conduit borrower as well as a conduit issuer. Indeed, the regulations pertaining to tax-exempt bond eligibility requirements generally acknowledge that an issuer "generally means the entity that actually issues the issue, and,

unless the context clearly requires otherwise, each conduit borrower of the issue."[25] In most instances, the conduit borrower is treated as the true obligor of the bonds for federal tax purposes other than section 103.[26]

More importantly, conduit issuers of qualified private activity bonds are generally taxpayers subject to direct income tax relating to qualification with the tax-exempt bond eligibility requirements relating to use of proceeds under section 150(b). Section 150(b) generally denies a conduit borrower an interest deduction on tax-exempt bonds to the extent that use of bond-financed property violates the applicable eligibility requirements. In that regard, conduit borrowers are more appropriately treated as taxpayers for purposes of section 6103 than conduit issuers, at least with respect to compliance issues relating to use of proceeds and bond-financed property.

In addition, in the case of qualified 501(c)(3) bonds, conduit borrowers are now required to provide detailed information returns relating to a number of tax-exempt bond compliance matters. If the filing of Form 8038 information returns provides an adequate basis for treating a conduit issuer as a taxpayer with respect to a tax-exempt bond, the filing of a Form 990 provides at least as sound a basis for treating a 501(c)(3) organization as a taxpayer with respect to the tax-exempt bonds benefiting the organization as reported in Schedule K to the Form 990.

The strict view that the conduit issuer is generally, appropriately, treated as the taxpayer, and not also (or equally) the conduit borrower, in practice creates unnecessary administrative burden for both the Service and for conduit issuers and conduit borrowers. For example, in an examination of tax-exempt bonds, the Service generally seeks a disclosure waiver from the conduit issuer to discuss the examination with the conduit borrower. Also, if a conduit borrower identifies a compliance problem and seeks to request a voluntary closing agreement from the Service, the Service generally requires full participation of the conduit issuer, even if the conduit issuer serves no meaningful role in the request.

These administrative procedures could be greatly simplified by recognizing the conduit borrower as a "taxpayer" for purposes of section 6103 of the Code in addition to the conduit issuer, and other procedural purposes, at least with respect to compliance issues relating to use of bond proceeds and bond-financed property.

The ACT does not recommend that the Service treat the conduit borrower as a taxpayer instead of the conduit issuer, but rather that the conduit borrower may also be appropriately treated as a taxpayer with respect to tax-exempt bond compliance matters. A more flexible interpretation of section 6103 of the Code would enable the Service to adopt procedures that would not require conduit issuer participation in cases where no substantial tax

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[25] Treas. Reg. §1.148-1(b).

[26] Rev. Rul. 68-590.

compliance objective is served. For example, the Service might determine, as a policy matter, that no substantial tax compliance purpose is served by requiring the rebate payment Form 8038-T to be signed by the conduit issuer or by requiring the conduit issuer to participate in every type of voluntary closing agreement request. Consistent with this approach, however, the Service might still determine as a policy matter that, for example, execution of a Form 8038 by the conduit issuer (in connection with issuance of bonds) and some degree of conduit issuer participation in bond examinations serves substantial tax compliance purposes.

6. Bond modifications

Under Treas. Reg. §1.1001-3 debt is treated as "exchanged" if the terms of the debt are significantly modified. This means that the original debt is treated as exchanged for the modified debt. Recent increase in financial distress in the tax-exempt bond market has increased the need for the Service to provide clear guidance, and clear procedures, relating to the modification of the terms of outstanding tax-exempt bonds.

a. *General Federal Income Tax Rules for Modifications of Debt Instruments*

Rules for whether a modification of the terms of a debt instrument results in an exchange (or "reissuance") are contained in Treas. Reg. §1.1001-3. These regulations apply to alterations of the terms of a debt instrument on or after September 24, 1996.[27] Accordingly, they will apply to all outstanding bonds, even if bonds were issued before that date.[28] These regulations contain special rules that apply only to tax-exempt bonds. In addition, Notice 2008-88, Notice 2008-41, and Notice 88-130 contain special rules for modifications of tax-exempt qualified tender bonds.

The general rule is that a "significant modification" results in a reissuance. The debt modifications call for a two-step analysis. First, it must be determined whether an alteration is a "modification." Second, it must be determined whether a modification is "significant."

Modifications. In general, alterations occurring by operation of the terms of a debt instrument are not modifications, while negotiated changes to the terms of a debt instrument are treated as modifications.[29] The failure of an issuer to perform its obligations under a debt instrument is not itself a modification.[30] Absent an agreement to alter other

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[27] Treas. Reg. §1.1001-3(h).

[28] The approach of the effective date rule of the Treas. Reg. §1.1001-3 is different than most tax-exempt bond regulations, which generally apply only to bonds issued after the effective date.

[29] The regulations provide that two types of alterations are modifications, even if they occur by operation of the terms of the debt: (1) An alteration that changes the obligor or changes the nature of the debt instrument (for example, from recourse to nonrecourse); and (2) An alteration that results in an instrument or property right that is not debt, unless the alteration occurs by a conversion option of the holder. Treas. Reg. §1.1001-3(c)(2). In most workout situations, these exceptions are not likely to be as important as the forbearance rule.

[30] Treas. Reg. §1.1001-3(b)(4)(i).

terms of the debt instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds (1) two years following the issuer's initial failure to perform; and (2) an additional period during which the parties conduct good faith negotiations or during which the issuer is in a bankruptcy case.[31]

The "significance" standard. In order to result in a reissuance, a modification must be "significant." In general, a modification is a significant modification only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[32] A number of bright-line rules apply to determine whether certain types of modifications are economically significant for this purpose. Bright-line rules apply to (1) changes in yield, (2) changes in timing of payments, (3) changes in obligor or security, and (4) changes in the nature of a debt instrument.[33]

b. *Special Considerations for Modifications of Conduit Bonds: Rev. Rul. 81-281*

Rev. Rul. 81-281 holds in general that interest on an issue of tax-exempt conduit bonds is not excludable from gross income after the terms of the underlying security and the terms of the bonds are substantially altered without action by the state or local government issuer. The specific facts of Rev. Rul. 81-281 are that a city issued mortgage-revenue bonds, and then loaned the proceeds to a borrower to finance construction of a factory.

Five years after the issue date, the borrower experienced financial difficulties and stopped making required payments on the mortgage note. The borrower transferred a deed to the bond trustee in lieu of foreclosure. The bondholders, the trustee, and the borrower agreed that the transfer, in lieu of foreclosure, fully discharged the borrower's obligations and the trustee did not call the bonds. After the discharge of the original borrowers obligations, a new borrower executed a mortgage note with different terms. The bondholders approved this arrangement, including the provision that the trustee would stop making principal payments sooner than under the original terms of the bonds. The semiannual payments of principal and interest made by the trustee to the bondholders were equal to the original semiannual payments, but the specific payments of principal and interest were different due to the change in terms of the underlying mortgage note. The city did not authorize, and was in no other way a party to, the mortgage between the conduit borrower and the trustee.

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[31] Treas. Reg. §1.1001-3(b)(4)(ii).

[32] Treas. Reg. §1.1001-3(e)(1).

[33] Other "bright-line" rules concern change in obligor or security and changes in the nature of a debt instrument. Certain special rules apply to tax-exempt debt under the Treas. Reg. §1.1001-3 that are not material to this discussion. See Treas. Reg. §1.1001-3(f)(6).

The IRS held that the modified bonds did not qualify as tax-exempt obligations because the obligation represented by the bonds on and after the date of the sale of the factory was different from the one the bonds previously represented because of the alteration to the terms. The IRS concluded that "because [the local government issuer] has neither authorized nor taken any action on the [new mortgage note] or on the bonds, the bonds on and after the date of the sale, do not represent the obligation of a political subdivision." The IRS reasoned that tax-exempt industrial development bonds "are in general characterized by the nominal participation of the political subdivision in a borrowing transaction that in substance is executed between bondholders and a nonexempt person."[34] The IRS emphasized, however, that it was affirming and distinguishing Rev. Rul. 79-262[35], which holds that the tax-exempt status of conduit bonds is not affected merely by the substitution of a new borrower for the original borrower.

The debt modification regulations clearly contemplate that they apply to modifications effected by a direct agreement between a bondholder and a conduit borrower. The section of the debt modification regulations that sets forth special rules for tax-exempt obligations provides as follows:

> In determining whether there is a significant modification of a tax-exempt bond … transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification … For example, a payment by a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.[36]

This reference suggests that, in general, the determination of what constitutes a "substantial modification" under Rev. Rul. 81-281 is governed by the debt modification regulations and, to at least that extent, the holding of Rev. Rul. 81-281 is obsolete. Rev. Rul. 81-281 remains important, however, for modifications of tax-exempt conduit bonds. Most importantly, the ruling holds that, if a conduit borrower and a bondholder agree to substantial modifications that cause bonds to be reissued, the reissued bonds will continue to be tax exempt only if the state or local government issuer participates in some manner.

There appears to be no express guidance, however, regarding the degree of participation that is required by the conduit issuer in such cases.

Moreover, there may be some question regarding whether the "significant modification" standards in the debt modification regulations govern in every instance. The most difficult case may be a modification that increases the rate of interest payable, without resulting in a reissuance under the debt modification regulations.

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[34] Citing Rev. Rul. 68-590, 1968-2 C.B. 66.

[35] 1979-2 C.B. 33. See also PLR 8504122 (October 31, 1984) and PLR 8236047 (June 9, 1982) following Rev. Rul. 79-262

[36] Treas. Reg. §1.1001-3(f)(6)(i).

The ACT recommends that the Service should provide clearer standards regarding when and how a conduit issuer must participate in the modification of outstanding bonds to preserve the tax-exempt status of the modified bonds.

First, the Service should clarify how Rev. Rul. 81-281 has been modified by the subsequent issuance of the debt modification regulations.

Second, the Service should clarify what specific actions will be treated as meeting the standard for "authorization" or "other action" set forth in Rev. Rul. 81-281. The ACT recommends that a timely filing of a Form 8038 relating to the modified bonds should in all cases suffice.[37]

Third, the ACT recommends that the Service should take action to better explain this requirement to conduit issuers, and to recommend that conduit issuers consider adopting policies or procedures regarding modifications of their bonds.

7. Special cases

a. *"Extraterritorial" conduit issuers, including state or local governments providing "issuing jurisdiction" and "host jurisdiction" public approval*

Section 147(f) of the Code generally requires that the "applicable elected representative" of a conduit issuer must approve each issue of qualified private activity bonds, after a public hearing following reasonable public notice or by voter referendum. This requirement also applies to most types of tax credit bonds that are not governmental bonds. In cases where the financed facilities are not located within the jurisdiction of the conduit issuer, the applicable elected representative of the governmental unit in which the financed facilities are located (the "host jurisdiction") must also provide public approval of the issuance of the bonds.

Other than the statutory requirement for "host jurisdiction" approval, no provision of the regulations or the Service's guidance or procedures specifies a tax compliance role for host jurisdictions providing public approval. Host jurisdictions providing public approval are not "conduit issuers" under the Services regulations, rulings or procedures.

The use of the "host jurisdiction" approval procedures for "extraterritorial" bond issuers appears to have significantly increased in recent years. For example, a conduit issuer in a single state may issue conduit bonds and loan the proceeds to a charitable health care system to finance its facilities located in many states. Many issuers are subject to specific statutory requirements, or have adopted specific procedures and guidelines, for

[37] Because reissued bonds are generally treated as "refunding bonds" for federal income tax purposes, reissued bonds would need to meet all applicable requirements for tax-exempt refunding bonds. For example, if a modification resulting in a reissuance involves extension of maturity, a new public approval may be required. The ACT recommends, however, that the approval requirements of Rev. Rul. 81-281 should be satisfied by timely filing of a Form 8038.

"extraterritorial" bond issues. These procedures generally, but not always, require the conduit borrower or the financed facilities to have some connection to the host jurisdiction issuing the bonds. Examples of these policies and procedures are set forth below.

The Colorado Health Facilities Authority is authorized by its enabling statute to finance facilities located outside of the State of Colorado if the health institution or an affiliate of such institution also operates or manages a healthcare facility within the State of Colorado.[38] The Colorado Educational and Cultural Facilities Authority is authorized under a similar enabling statute to finance facilities located outside of the State of Colorado. The Colorado Educational and Cultural Facilities authority has adopted guidelines and requirements for multi-state financing that, among other things, require a financing of benefits to the State of Colorado, and require "host jurisdiction" approvals, but do not otherwise address a federal tax compliance role.[39]

The Indiana Financing Authority has adopted "Multi-State Health Care Transaction Requirements" under which it generally focuses on the portion of a particular bond issue used to finance facilities within the State of Indiana. Under these procedures, the Authority will consider financing any project with greater than 50% of the proceeds of the issue to be used for facilities within the State of Indiana. Financings not meeting this 50% threshold may also be considered based on certain factors.

The Public Finance Authority, a newly formed conduit issuer in Wisconsin, does not have specific requirements for a connection between the financed project and the State of Wisconsin. The advent of conduit issuers that have authority to issue bonds for conduit borrowers, with which they have little or no other relationship, raises a number of policy issues for Congress, the Service, and the community of conduit issuers and conduit borrowers regarding the meaning of the oversight role of conduit issuers.[40]

"Extraterritorial" conduit issuers raise at least the following compliance questions for the state and local governments involved: (1) should conduit issuers adopt policies and procedures for bond issues that finance facilities outside of their jurisdictions; and (2) should conduit issuers adopt policies and procedures for when and how they will provide "host jurisdiction" for the financing of facilities located in their jurisdiction, but not financed by them as the conduit issuer.

Because the loans made with proceeds of tax-exempt bonds by a conduit issuer to conduit borrowers generally must serve a governmental purpose (as contrasted with an investment

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[38] C.R.S. 25-25-101 et seq.

[39] C.R.S. 23-15-103.

[40] See Yvette Shields, "*Wisconsin Conduit Issuer on the March*" THE BOND BUYER, Wednesday April 13, 2011, in which different conduit issuer officials are reported to have raised questions regarding whether a conduit issuer can play a meaningful oversight function when it issues bonds on behalf of a borrower with which it had no other connection. See *also* Stephanie Strom, *Nonprofits Turn to Out-of-State Options for Bonds*, THE NEW YORK TIMES, January 24, 2011.

purpose), the particular requirements adopted by conduit issuers on multistate issues may vary depending on particular state laws concerning public purpose.[41] In light of the "public purpose" constraints, many conduit issuers appear to be subject to, or have adopted, particular requirements for acting as an "extraterritorial" conduit issuer.

Fewer conduit issuers, however, appear to have adopted policies and procedures for when and how a state or local government will act to provide a "host jurisdiction" public approval in cases where bonds are issued by a different state or local government. The ACT does not recommend that the Service require any particular policies or procedures other than the public approval required by section 147(f) of the Code. The ACT does recommend, however, that it is appropriate for the Service to raise with state and local governments the question of whether policies and procedures for "host jurisdiction" approvals should be considered. For example, possible approaches for such approvals would be for a host jurisdiction to be provided assurance that the issuing jurisdiction has in place adequate tax-exempt bond compliance policies and procedures and for the issuing jurisdiction to provide notification of any examinations or closing agreement requests in connection with the bonds or the approved facilities.

b. *Multijurisdictional composite issues*

Most of the tax-exempt bond eligibility requirements apply to an entire "issue" of bonds, as defined under section 150 of the Code. Under that definition, bonds issued by different state or local government conduit issuers to make loans to the same borrower, or related borrowers, may be treated as a single "issue." For example, different conduit issuers in multiple different jurisdictions may separately issue conduit bonds and loan the proceeds to a charitable health care system to finance its facilities located in many different jurisdictions. If the different conduit bonds are sold at the same time pursuant to the same plan of financing, all of the conduit bonds will generally be treated as a single bond issue.[42]

To date, the Service has provided only limited guidance regarding procedures for such multijurisdictional bond issues.[43]

In practice, however, the Service appears to have treated any of the conduit issuers of such a composite bond issue as the "taxpayer" for purposes of bond examinations, closing agreements, and filings. The ACT recommends that the Service should provide guidance

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[41] Treas. Reg. §1.148-1(b) provides that a "purpose investment" means "an investment that is acquired to carry out the governmental purpose of an issue." At least in the case of qualified private activity bonds, a conduit bond issue generally would not qualify as tax exempt if the conduit loans made with proceeds of the bond issue did not qualify as purpose investments. In other words, the compliance with the federal income tax requirements for such a bond issue appears to depend on that state law conclusion that the conduit loan furthers a bona fide governmental purpose other than merely generating fees for the conduit issuer.

[42] Treas. Reg. §1.150-1(c)(3).

[43] Regulations concerning the information return requirement that applies to tax-exempt bonds contemplate that, in the case of a composite issue, each separate issuer will file a Form 8038. Treas. Reg. §1.149(e)-1(e).

formally adopting this practice. In providing such guidance, however, the ACT recommends that the Service consider procedures to require that notification of dealings with the Service be provided to all conduit issuers of a composite bond issue. For example, suppose a composite bond issue includes bonds issued by six different conduit issuers for facilities of the same conduit borrower located in six (or more) different jurisdictions. In such a case, it should be sufficient for closing agreements and information returns to be executed by only one of the conduit issuers. Requiring direct participation by all of the conduit issuers would impose an unreasonable and unnecessarily administrative burden.

The ACT recommends, however, that the best solution to interpretive and practical concerns posed by multijurisdictional composite issues is to more generally revise current procedures of the Service to permit the conduit borrower to be treated as the "taxpayer" for purposes of dealings with the Service, including examinations, requests for closing agreements and information returns. Under such an approach, the Service could reasonably require the conduit borrower to provide notification to each conduit issuer of all administrative dealings with the Service.

c. *Conduit bonds supported by true leases and similar arrangements*

A number of types of tax-exempt bond issues closely resemble conduit bond issues but have not customarily been treated as "conduit financing issues" under the tax-exempt bond eligibility requirements. The most important of these types of bonds are "exempt facility bonds" issued under section 142(a) of the Code that finance facilities that are required to be owned by a state or local government under section 142(b) of the Code, which are bonds issued for airports, docks and wharves, mass commuting facilities, and environmental enhancements to hydroelectric facilities. Also, private activity bonds issued for solid waste disposal facilities that do not receive an allocation of volume cap are required to finance facilities owned by a state or local government. Certain governmental bonds closely resembling conduit issues may be supported by leases that are not treated as debt obligations.

Such tax-exempt bond issues for governmentally-owned facilities are customarily supported by leases or concession agreements that provide for payment of all debt service on the bonds. Section 142(b)(1)(B) of the Code sets forth a safe harbor under which the facilities subject to such arrangements will be treated as owned by a state or local government.[44]

Certain technical federal tax requirements that apply to conduit bond issues do not apply to these types of bond issues supported by true leases and similar arrangements. For example, it is customary not to treat true leases and similar arrangements as "purpose investments" subject to arbitrage yield restrictions, even though such leases and other arrangements may provide for the payment of all of the debt service on a bond issue. With

[44] Section 146(h)(2) of the Code provides for a similar safe harbor for bonds issued to finance solid waste disposal facilities that do not receive a volume cap allocation.

respect to most aspects of compliance with tax-exempt bond eligibility requirements, however, these types of bond issues closely resemble conduit bonds. For example, the bond documents for these bond issues commonly require the lessee or service provider to comply with requirements relating to expenditures of bond proceeds and use of bond-financed property.

The ACT recommends that the Service should include references to bond issues supported by true leases and similar agreements in its procedures and guidance relating to conduit bond issues. The ACT further recommends that it is appropriate for the Service to raise with state and local governments the question of whether, or the extent to which, any adopted policies and procedures for conduit bond issues should also apply to these types of bond issues.

d. *"On behalf of" issuers*

A number of published rulings of the Service provide that tax-exempt bonds may be directly issued by a nonprofit organization acting "on behalf of" a state or local government, as well as directly by a state or local government. Under Rev. Rul. 63-20 and Rev. Proc. 82-26, "on behalf of" bond issues can take a number of different forms. Most commonly, the "on behalf of" issuer in substance acts only as the conduit issuer, but, much less commonly, the "on behalf of" issuer can also be a user of the bond proceeds and the real obligor of the bonds. In some cases, it may be difficult or administratively burdensome for the Service and the conduit borrower to deal with the "on behalf of" issuer. For example, an "on behalf of" issuer may be formed only for the purpose of issuing particular bonds, and have no other ongoing functions. Accordingly, the ACT recommends that the Service's procedures clarify that the Service may treat the state or local government on behalf of which bonds are issued as the "taxpayer."

8. Procedural implications of the "change of use penalties" set forth in section 150(b) of the Internal Revenue Code

The Tax Reform Act of 1986 enacted section 150(b) of the Code which provides that a change of use of property financed with private activity bonds, to a use not qualifying for tax-exempt financing, generally results in loss of income tax deductions for rent, interest, or equivalent amounts by the person using the property in the nonqualified use. Also, under this provision, 501(c)(3) organizations realize unrelated business income with respect to any such use.

The enactment of section 150(b) of the Code is particularly significant because it provided, for the first time, that failure to comply with tax-exempt bond requirements relating to use of proceeds would result in direct additional income tax liability to a conduit borrower. In other words, the effect of section 150(b) was to position conduit borrowers in a direct "taxpayer" relationship to the Service, at least with respect to required use of bond-financed property.

In this light, there appears to be at least as much basis to treat conduit borrowers as "taxpayers" under the Service's procedures as conduit issuers, at least with respect to compliance relating to use of proceeds.

The ACT recommends that the Service take into account the provisions of section 150(b) of the Code in adopting administrative procedures that are more flexible, and that recognize that conduit borrowers appropriately can be treated as "taxpayers" in connection with administrative dealings with the Service relating to tax-exempt bond compliance.

9. Policy and procedural options for conduit issuers

In general, the ACT does not recommend that the Service should dictate to state and local conduit issuers the policies and procedures they should adopt relating to administration of the federal income tax requirements for tax-exempt bonds and tax credit bonds. The ACT believes, however, that it is appropriate for the Service to open a dialogue with state and local government conduit issuers by clearly explaining the required role of conduit issuers and framing different policy approaches that conduit issuers may adopt.

a. *Procedures relating to public hearings*

Section 147(f) of the Code generally requires that the "applicable elected representative" of a conduit issuer must approve each issue of qualified private activity bonds, after a public hearing following reasonable public notice or by voter referendum. This requirement also applies to most types of tax credit bonds that are not governmental bonds.

The public approval requirement is one of the most significant responsibilities assigned to conduit issuers in the Code. Existing regulations set forth guidance regarding the manner of public notice, public hearings and public approval. In general, the notice of hearing and the approval must contain:

> (1) a general, functional description of the type and use of the facility to be financed;
> (2) the maximum aggregate face amount of obligations to be issued with respect to the facility;
> (3) the initial owner, operator, or manager of the facility; and
> (4) the prospective location of the facility by its street address or, if none, by a general description designed to inform readers of its specific location.

Public notice is presumed reasonable if: (1) it is published no fewer than 14 days before the hearing; and (2) it is reasonably designed to inform residents of the affected governmental units. Notice may be provided in the same manner and the same locations as required of the approving governmental unit for any other purposes for which state law specifies a notice of public hearing requirement.

Proposed regulations under section 147(f) published on September 8, 2008, (corrected October 7, 2008) would provide conduit issuers with substantially more flexibility in the content and manner of notices of public hearing and public approval.

Regulations under section 147(f) concern only the minimum requirements for public approval, and do not provide or imply that it is not appropriate for a conduit issuer to adopt additional procedural requirements for public approval. For example, a conduit issuer could require as a matter of policy to require a more detailed description of the facilities to be

financed than the federal income tax regulations require. Accordingly, one key policy option of a conduit issuer is whether to adopt procedures setting forth additional requirements for public approval.

b. *Policies relating to designation of officials to take post-issuance actions, if required*

Other than the statutory requirement that an "applicable elected representative" must provide public approval, none of the provisions of the Code, regulations, or other guidance specifically provides that particular officials of a conduit issuer have specific tax compliance responsibilities. The regulations and the Service's other guidance and procedures require that a conduit issuer must be involved in a number of different actions taken after the date of issuance of a bond issue, including: (1) responding to an examination of the bond issue by the Service; (2) submitting a voluntary closing agreement request to the Service; (3) submitting a private letter ruling request to the Service; (4) implementing a "remedial action" upon the change of use of bond-financed property, including, where necessary, filing a supplemental Form 8038 and filing a notice of defeasance; (5) executing a "hedge identification" permitting an interest rate swap or other interest rate hedge to be taken into account in determining bond yield; and (6) approving a modification of the terms of the bonds in cases where a modification results in a "reissuance" for federal income tax purposes.

Accordingly, one procedure that may be considered by a conduit issuer is whether to designate one or more officials, on a standing basis, to be responsible for taking such actions after the date of issuance of a bond issue.

c. *Policies relating to post-issuance compliance*

On June 10, 2009, the ACT submitted a report on "*Record Retention Requirements for Tax-Exempt Bonds and Tax Credit Bonds: A Specific Proposal for Published Guidance,*" which set forth a detailed discussion of post-compliance issues relating to tax-exempt and tax credit bonds. The report included a specific proposal for a revenue procedure identifying the core elements of reasonable bond compliance procedures that must be adopted and implemented to qualify for favorable record retention safe harbors. These core elements were identified as: (1) reasonable procedures for assignment of compliance responsibilities; (2) reasonable procedures for the establishment and maintenance of books and records; (3) reasonable procedures for compliant investment of gross proceeds; (4) reasonable procedures for the review and allocation of bond proceeds; (5) reasonable procedures for periodic monitoring of use of financed property; and (6) reasonable susceptibility to audit. The proposed revenue procedure acknowledged by specific examples and other provisions that, in light of the great variety of bond issuers and borrowers, a "one size fits all" approach is not workable, and that issuers should have considerable flexibility to meet these core elements.

For the reasons set forth in the 2009 ACT Report, a conduit issuer may consider whether to include specific references to some or all of these core elements in its compliance procedures.

i. Designation of compliance responsibilities

The policy options for a conduit issuer relating to designation of compliance responsibilities include: (1) whether to provide that the conduit issuer is responsible for any compliance responsibilities after the date of issuance; (2) whether to designate a particular conduit issuer official or officials responsible for post-issuance compliance; and (3) whether to require conduit borrowers to identify a particular official or officials responsible for post-issuance compliance.

ii. Adoption of policies and procedures by conduit borrowers

The policy options for a conduit issuer relating to adoption of policies and procedures by conduit borrowers include: (1) whether to require the conduit borrower to demonstrate that it has adopted written post-issuance compliance procedures before the approval of a bond issue; and (2) if the conduit issuer requires conduit borrowers to adopt written compliance procedures, whether those procedures must contain certain core elements (for example, the five core elements identified in the 2009 ACT Report).

iii. Rebate and yield restriction compliance

The policy options of a conduit issuer relating to rebate and yield restriction compliance include: (1) whether the conduit issuer should delegate to the conduit borrower the ability to invest bond proceeds, or whether the conduit issuer should invest bond proceeds; (2) whether the conduit issuer should delegate the responsibility to the conduit borrower to comply with rebate and arbitrage requirements; (3) whether the conduit issuer should approve the rebate service provider retained by the conduit borrower; and (4) what limitations the conduit issuer imposes on its own fees charged to the conduit borrower.

iv. Expenditure of bond proceeds

The policy options of a conduit issuer relating to expenditure of bond proceeds include: (1) whether the conduit issuer should delegate to the conduit borrower the ability to determine how bond proceeds are spent and the responsibility to ensure that all expenditures are compliant; (2) whether the conduit issuer should approve expenditures, either in a final review or otherwise; and (3) if the conduit issuer does not approve expenditures, whether the conduit issuer should require the conduit borrower to provide certifications of expenditures, either in the form of a final bond proceeds allocation certificate or otherwise.

v. Change of use and remedial actions

The regulations provide for a number of “remedial actions” that may be taken to preserve the qualification of a bond issue in cases where a “change of use” of the financed property results in noncompliance with requirements relating to use of bond proceeds. For example, in the case of qualified 501(c)(3) bonds, the following types of remedial actions may be

available: (1) redemption or defeasance of nonqualified bonds[45]; (2) alternative use of disposition proceeds received from the sale for cash of bond-financed property[46]; and (3) alternative qualifying use of a facility.[47] Under the regulations, the conduit issuer is required to participate in some, but not all, of these remedial actions. For example, in the case of a remedial action involving the redemption of nonqualified bonds within 90 days of a deliberate action resulting in noncompliance, no participation by the conduit issuer is required. In the case of a remedial action involving the defeasance of bonds which cannot be redeemed within 90 days of the deliberate action resulting in noncompliance, participation by the conduit issuer is required, because the conduit issuer must execute and file a notice of defeasance with the Service. In the case of a remedial action involving alternative qualifying use of disposition proceeds, participation by the conduit issuer is required, because the conduit issuer must execute and file a supplemental Form 8038, and may be required, depending on the facts and circumstances, to provide a new public approval of the facilities to be financed with disposition proceeds.

A number of detailed requirements must be met in the case of each remedial action.

Accordingly, the policy options for a conduit issuer relating to remedial actions include: (1) whether to require the conduit borrower to include the participation and approval of the conduit issuer in all remedial actions, even in those cases where the tax regulations do not require conduit issuer participation; and (2) whether to require a bond counsel opinion relating to all or some types of remedial actions.

vi. Record retention

The 2009 ACT Report discusses in detail record retention issues relating to tax-exempt bonds and tax credit bonds.

The policy options for a conduit issuer relating to record retention requirements include: (1) whether to specifically designate which types of records must be retained by conduit issuers and which types of records, if any, will be retained by the conduit issuer; and (2) whether to identify a specific period during which records must be retained (for example, three years after the April 15 of the calendar year immediately following the retirement of the last bond of an issue).

d. *Policies relating to compliance with safe harbors*

Regulations and published rulings set forth a number of safe harbors under which a bond issue is conclusively or rebuttably treated as meeting a tax-exempt bond eligibility requirement. These safe harbors include: (1) the safe harbor for purchase of guaranteed

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[45] Treas. Reg. §1.141-12(d).

[46] Treas. Reg. §1.141-12(e).

[47] Treas. Reg. §1.141-12(f).

investment contracts and yield restricted defeasance escrows, under which a specified "three-bid" procedure may establish fair market value[48]; and (2) the safe harbor for the amount of broker's commissions and other similar costs relating to the purchase of guaranteed investment contracts and yield restricted defeasance escrows that may be treated as part of the cost of the investment.[49]

The policy options for a conduit issuer relating to such safe harbors include: (1) whether to require compliance with such safe harbors unless an opinion of counsel or other acceptable indication of compliance is provided; and (2) whether to require notification to the conduit issuer of situations under which certain safe harbor requirements are not met.

e. *Policies relating to issuance of extraterritorial bond issues*

Other than the statutory requirement that a bond issue receive both "issuer approval" and "host approval" in the case of bonds that finance a facility located outside of the jurisdiction of the issuer, the Service has not provided guidance on appropriate procedures for extraterritorial bond issues. The policy options for a state or local government acting as the issuer of such an extraterritorial issue, however, include: (1) whether to adopt policies specifying the nature and extent of the relationship of the conduit borrower or the extraterritorial financed facility to the issuer (for example, a requirement that the conduit borrower conduct operations within the jurisdiction of the issuer); and (2) whether to adopt procedures that provide for notifying the host jurisdiction of any post-issuance events (for example, an examination of the bond issue).

f. *Policies relating to providing "host approval"*

The Service has not identified any compliance or oversight role for a state or local government providing "host approval" of a bond issue for purposes of the statutory public approval requirement. The policy options for a state or local government providing "host approval," however, include: (1) whether to require representations or assurances that the issuing jurisdiction has adopted compliance policies or procedures (for example, a policy requiring that the conduit borrower has adopted and implemented post-issuance compliance procedures); (2) whether to require the issuing jurisdiction to provide notification to the host jurisdiction of any administrative contacts with the Service after the date of issuance (for example, notification of examinations and voluntary closing agreement requests); and (3) whether to require the issuing jurisdiction to provide notification to the host jurisdiction of any change of use of the property financed with the bonds, within or outside of the host jurisdiction.

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[48] Treas. Reg. §1.148-5(d)(3).

[49] Treas. Reg. §1.148-5(e)(2)(iii).

g. *Policies relating to composite bond issues*

Under certain circumstances, bonds issued by two or more conduit issuers may be treated as part of the same "issue" for purposes of the tax-exempt bond eligibility requirements. In general, in such cases a compliance problem relating to bonds issued by one conduit issuer could cause the bonds of all of the conduit issuers to fail to meet the applicable tax-exempt bond requirements. The policy options for a conduit issuer participating in a composite bond issue include: (1) whether to require representations or assurances that the other conduit issuers of the composite issue have adopted compliance policies for procedures; (2) whether to require the other conduit issuers of the composite issue to provide notification to the conduit issuer of any administrative contacts with the Service after the date of issuance; (3) whether to require the other conduit issuers to provide notification to the conduit issuer of any change of use of the property financed with the composite issue bonds; and (4) whether to require that a "multipurpose allocation" be made with respect to the conduit bond issue for purposes of the requirements relating to use of financed property, so that a compliance problem relating to use of financed property financed by bonds of another conduit issuer will not necessarily cause the bonds of the conduit issuer to fail to qualify as tax-exempt.

h. *Procedures relating to responding to an IRS bond examination*

Current procedures of the Service treat the conduit issuer as the "taxpayer" in an examination. Although the ACT recommends that the Service revisit this approach, under current procedures, the conduit issuer is required to participate in a bond examination. The policy options for a conduit issuer relating to bond examinations include: (1) whether the conduit issuer should adopt a standing procedure or policy identifying a particular official or officials who have responsibility for responding to bond examinations by the Service; (2) whether the conduit issuer should directly handle the examination, or assign to the conduit borrower responsibilities for handling the examination; (3) whether the conduit issuer should retain its own counsel to respond to a bond examination; (4) whether the conduit issuer should permit the bond counsel firm that rendered the approving opinion to represent the conduit issuer in the examination; and (5) whether the conduit issuer should permit a single counsel to represent both the conduit issuer and the conduit borrower in the examination.

i. *Procedures relating to seeking a voluntary closing agreement*

Current procedures of the Service treat the conduit issuer as the "taxpayer" in a voluntary closing agreement request. Although the ACT recommends that the Service revisits this approach, under current procedures the conduit issuer is required to participate in a voluntary closing agreement request. The policy options for a conduit issuer relating to voluntary closing agreement requests include: (1) whether the conduit issuer should adopt a standing procedure or policy identifying a particular official or officials who have responsibility for participating in such requests; (2) whether the conduit issuer should retain its own counsel in connection with such a request; and (3) whether the conduit issuer should permit a single counsel to represent both the conduit issuer and the conduit borrower in such a request.

j. *Policies relating to potential conflicts of interest*

Attorneys representing conduit issuers and conduit borrowers are subject to conflict of interest rules under state law and Circular 230. The participation of two different "issuers" in conduit issues raises a host of possible conflict of interest questions. The policy options for a conduit issuer relating to dealing with such conflict of interest questions include: (1) whether to permit a single counsel to represent the conduit issuer and the conduit borrower in an examination of a bond issue; and (2) whether to permit a single counsel to represent the conduit borrower in a voluntary closing agreement request.

10. Recommendations

The ACT recommends that the Service take the following steps with respect to the role of conduit issuers.

a. The Service should revisit its apparent position that, in general, a conduit borrower is not treated as a taxpayer for purposes of administration of the requirements relating to tax-advantaged bonds. The Service generally should be able to regard conduit borrowers as taxpayers for purposes of section 6103 to the same extent as conduit issuers. At a minimum, the Service should treat conduit borrowers as taxpayers to the same extent as conduit issuers for all purposes relating to qualified use of bond proceeds (that is, to the extent that noncompliance could affect the income tax treatment of a conduit borrower). This step would simplify and reduce costs of the Service's examinations and voluntary compliance programs relating to tax-advantaged bonds. As a policy matter, the Service could reasonably impose a requirement that the conduit issuer be advised of any proceedings between the Service and the conduit borrower, and that the conduit issuer be afforded the opportunity to participate in any such proceeding, but conduit issuer involvement should not be required in all cases. In addition, any conduit issuer requiring full procedural participation in tax compliance matters, as a matter of policy, could so require in its contracts with conduit borrowers.

b. Accordingly, the Service should revise its procedures relating to private letter rulings to permit conduit borrowers to directly seek private letter rulings, at least with respect to rulings that pertain to qualified use of bond proceeds.

c. The Service should revise its procedures relating to voluntary closing agreements to permit conduit borrowers to directly seek voluntary closing agreements, at least with respect to voluntary closing agreement requests that pertain to qualified use of bond proceeds.

d. The Service should provide more guidance and outreach to conduit borrowers relating to allocation of the various volume caps for different types of tax-advantaged bonds.

e. The Service should clarify the specific actions that a conduit issuer is required to take to preserve the tax-advantaged status of bonds when a modification of the bonds results in a "reissuance." In particular, the Service should expressly provide that the

timely filing of a Form 8038 is sufficient to meet the requirement that the conduit issuer participate in the approval of the reissued bonds.

f. The Service should take more formal steps to open a dialogue with conduit issuers regarding the appropriate tax compliance role of conduit issuers. In general, the ACT recommends that the Service should acknowledge that a range of different degrees of conduit issuer involvement may be appropriate, and is properly, in large part, determined by state or local government policy decisions. The Service should help conduit issuers identify and consider the range of different approaches. The ACT, in general, recommends, however, that a best practice is that conduit issuers be encouraged at least to adopt procedures that make inquiries regarding the tax compliance procedures and policies of a conduit borrower as of the date of issuance of each tax-advantaged bond.

g. The Service should prepare and release a publication with regard to the role of conduit issuers ("Your Role as a Conduit Issuer of Bonds"). The publication should: (1) describe the roles required of conduit issuers under the Code, regulations, published rulings, and current IRS procedures; (2) suggest procedures that conduit issuers may wish to consider to fulfill these required roles; and (3) frame different policy options, that conduit issuers may wish to consider relating to tax administration, that are in addition to the minimum responsibilities that apply to conduit issuers. A proposed draft of such a publication is attached.

Appendix A:
Form of Survey Letter to Conduit Issuers and Conduit Issuer Associations

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CONDUITISSUER2

1. INTRODUCTION

Members of the Internal Revenue Service Advisory Committee on Tax Exempt and Governmental Entities ("ACT") are preparing a report on the role of conduit issuers relating to the federal income tax requirements that apply to tax-exempt bonds and and tax credit bonds. The members of the ACT are individuals and do NOT act in any manner on behalf of the Internal Revenue Service.

The members of the Tax Exempt Bond subcommittee of the ACT invite conduit issuers to respond to the attached survey, which sets forth questions relating to practices and procedures. The members of the ACT will compile responses to be included in their report to the IRS Commissioner. This survey is being distributed by several organizations to their constituencies; we ask that you only respond once to the survey.

The members of the ACT will not share individual responses with the Internal Revenue Service, except with respect to information that is otherwise available to the general public (e.g., information on an issuer's public webisite). The ACT does expect to share summaries of responses with the Internal Revenue Service except with respect to information that is available to the general public (e.g., public websites).

The members of the ACT hope that the report will make an important contribution to the dialogue between the Internal Revenue Service and State and local governments regarding administration of the Federal income tax rules relating to tax-exempt bonds and tax credit bonds. Your input is greatly appreciated.

If you have questions, please do not hesitate to contact George Magnatta at 215-972-7126, Michael Bailey at 312-832-4504 or David Cholst at 312-845-3862. Thank you for your help on this matter.

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2.

1. Are you an operating authority/agency? That is, do you perform functions in addition to acting as the issuer of bonds?

- ◯ Yes
- ◯ No

2. Do you have a full-time staff? Part time staff?

☐ Full Time ☐ Part Time

3. Please indicate the average number of conduit bond issues issued during the past five (5) years for each of the bond categories:

	0-1	2-10	11-50	Over 50
a. Private Activity Bonds (other than Qualified 501(c)(3) Bonds)	◯	◯	◯	◯
b. Qualified 501(c)(3) Bonds	◯	◯	◯	◯
c. Governmental (non-private activity) conduit issues	◯	◯	◯	◯

4. Please indicate the aggregate principal amount of conduit bond issues issued during the past five (5) years for each of the bond categories:

	None	Under $5 Million	$5-20 Million	$20-100 Million	$100-500 Million	Over $500 Million
a. Private Activity Bonds (other than Qualified 501(c)(3) Bonds)	◯	◯	◯	◯	◯	◯
b. Qualified 501(c)(3) Bonds	◯	◯	◯	◯	◯	◯
c. Governmental (non-private activity) conduit issues	◯	◯	◯	◯	◯	◯

5. Do you have an internal review procedure to determine whether a transaction satisfies the federal tax requirements for tax-exempt or tax-credit bonds?

- ◯ Yes
- ◯ No

Describe

5

6

CONDUITISSUER2

6. Do you require a preliminary bond counsel opinion regarding federal income tax compliance (e.g., based upon a preliminary analysis of the facts, bond counsel believes that it will be able to render an opinion regarding the exclusion of interest from gross income for federal income tax purposes) before you hold a public hearing for tax purposes ("TEFRA hearing")? Before you provide a volume cap allocation?

- ◯ Do not require a preliminary bond counsel opinion
- ◯ Require a preliminary bond counsel opinion before TEFRA hearing held
- ◯ Require a preliminary bond counsel opinion before provision of volume cap allocation
- ◯ Other (please describe)

7. Do you require a conduit borrower to demonstrate its creditworthiness, that is, its ability to repay the loan?

- ◯ Yes
- ◯ No

8. Do you require a conduit borrower to demonstrate that it has adopted post-issuance compliance procedures before you will issue the conduit bonds?

- ◯ Yes
- ◯ No

9. If yes, what do you require the post-issuance compliance procedures to demonstrate?

- ☐ Qualified expenditure of proceeds
- ☐ Economic life of financed assets
- ☐ Compliance with public approval requirements
- ☐ Compliance with Arbitrage and rebate requirements
- ☐ Other (please specify)

CONDUITISSUER2

10. Have you designated specific officials or employees to oversee continuing compliance by the conduit issuer?

- ◯ Yes
- ◯ No

11. Do you require that the financing documents contain tax representations and covenants with specific wording supplied by the conduit issuer?

- ◯ Yes
- ◯ No

12. Do you require that the proceeds of the transaction be invested at the direction of the issuer? Or a party related to the issuer? Or a party hired by the issuer? Or by the conduit borrower?

- ◯ Issuer
- ◯ Party Related to the Issuer
- ◯ Party Hired by the Issuer
- ◯ Conduit borrower

13. Do you require the use of a trustee to hold bond proceeds before expenditure?

- ◯ Yes
- ◯ No

14. If you are the conduit issuer of private activity bonds or qualified 501(c)(3) bonds, do you require that the conduit borrower have compliance procedures in addition to provisions in the bond documents for particular audit issues?

- ☐ Yes
- ☐ No
- ☐ Must be written

15. Do you require that the conduit borrower provide periodic compliance reports or statements?

- ☐ Yes, must provide information to trustee
- ☐ Yes, must provide information to issuer
- ☐ Yes, must provide information to other
- ☐ No (IF YOUR ANSWER IS NO, PLEASE SKIP TO QUESTION #20)

CONDUITISSUER2

16. How often do you require such report or certification?

- ◯ Semi-annually
- ◯ Annually
- ◯ Biannually
- ◯ Less frequently than biannually

17. If you require the tax compliance reports/statements to be provided to a person other than or in addition to the conduit issuer, do you require that other person to determine continuing tax compliance?

- ◯ Yes
- ◯ No

18. How often must the tax compliance information be provided?

- ◯ Do not require information to be provided
- ◯ Annually or more frequently
- ◯ Less than annually but more than every five (5) years
- ◯ Less than every five (5) years but at least once
- ◯ Never

19. Do the contents of periodic tax compliance reports require--

- ☐ Private use compliance
- ☐ General compliance
- ☐ Rebate compliance
- ☐ Other

20. In the case of an IRS examination of conduit bonds, do you have any procedures that must be followed?

- ☐ Yes
- ☐ No

CONDUITISSUER2

21. In the case of an IRS examination of conduit bonds, who pays the costs and expenses thereof?

- ◯ Issuer
- ◯ Conduit borrower
- ◯ Issuer and conduit borrower may share costs
- ◯ Other arrangement (please explain)

22. In the case of an IRS examination of conduit bonds, do you have a policy or procedure that you will retain your our own counsel?

- ◯ Yes
- ◯ No

23. Do you have procedures in place for applying for relief under the IRS' voluntary compliance procedures (VCAP)?

- ◯ Yes
- ◯ No

24. Do you have procedures regarding identification of interest rate swaps for tax purposes?

- ◯ Yes
- ◯ No

25. Do you have procedures under which you retain records for a conduit bond issue relating to events and actions after the date of issuance?

- ◯ No (IF YOUR ANSWER IS "NO", PLEASE SKIP TO QUESTION #27)
- ◯ Investment records (rebate and yield restriction)
- ◯ Expenditure records (e.g., project completion certificates)
- ◯ Private use records
- ◯ Remedial action records
- ◯ Other (please specify)

CONDUITISSUER2

26. Do you have procedures under which you retain records for a conduit bond issue for a minimum period of time?

- ◯ No (IF NO, SKIP TO QUESTION #27)
- ◯ Three years after retirement of the bond issue
- ◯ General IRS statutory period for limiting assessment (three years after the April 15 of the calendar year following the date of retirement of the bond issue)
- ◯ Six years after retirement of the bond issue
- ◯ Other (please specify)

27. Do you act as the conduit issuer for facilities that are located outside of your geographic jurisdiction?

- ◯ Yes
- ◯ No

28. If your answer if "yes", do you have procedures for coordinating with the jurisdiction providing host approval?

- ◯ Yes
- ◯ No

29. Dol you act as the "host jurisdiction" providing public approval for tax purposes in cases when the conduit bonds are issued by another issuer outside of your geographic jurisdiction?

- ◯ Yes
- ◯ No (IF YOUR ANSWER IS NO, SKIP TO QUESTION #31)

30. If your answer is "yes," do you have procedures for coordinating with the conduit issuer?

- ◯ Yes
- ◯ No

31. Do you charge a fee to the conduit borrower?

- ☐ Yes
- ☐ No
- ☐ Fee is a percentage of amount of bonds
- ☐ Fee is a set dollar amount

CONDUITISSUER2

32. For what purpose(s) do you use the fees?

Appendix B:

(Proposed IRS Publication)

Your Role as a Conduit Issuer of Bonds

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The office of Tax Exempt Bonds ("TEB"), of the Internal Revenue Service (IRS), Tax Exempt and Government Entities division, offers specialized information and services to the municipal finance community. Municipal bonds provide tax-exempt financing for certain qualified purposes including the construction of hospitals, residential rental housing, solid waste facilities, colleges and universities and cultural institutions. Tax-exempt financing also is available for the furtherance of governmental purposes.

This IRS Publication _____, *Your Role as a Conduit Issuer of Bonds*, provides an overview for state and local governments of the role of the conduit issuer with respect to tax compliance in municipal financing arrangements commonly known as conduit financings. All applicable federal tax law requirements must be met to ensure that interest earned by bondholders is exempt from taxation under section 103 of the Internal Revenue Code (the "Code"). In addition to tax-exempt bonds, certain tax credit bonds may also be issued as conduit bonds. The overview provided in this publication is also intended to apply to tax credit bonds.

For information regarding the more specific rules applicable to qualified 501(c)(3) bonds, other qualified private activity bonds and governmental bonds, see IRS Publications 4077, *Tax-Exempt Bonds for 501(c)(3) Charitable Organizations*; 4078, *Tax-Exempt Private Activity Bond*; and 4079, *Tax-Exempt Governmental Bonds*, respectively. TEB also provides detailed information on specific provisions of the tax law through IRS publications (available online) and through outreach efforts as noted on the TEB Web site at *www.irs.gov/bonds*.

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BACKGROUND

Tax-exempt bonds are valid debt obligations of state and local governments, commonly referred to as “issuers”— the interest on which is tax-exempt. This means that the interest paid to bondholders is not includable in their gross income for federal income tax purposes. This tax-exempt status remains throughout the life of the bonds provided that all applicable federal tax laws are satisfied. Various requirements apply under the Code and Income Tax Regulations (the “Treasury regulations”) including, but not limited to, information filing and other requirements related to issuance, the proper and timely use of bond-financed property, and arbitrage yield restrictions and rebate requirements. The benefits of tax-exempt bond financing can apply to the many different types of municipal debt financing arrangements through which government issuers obligate themselves, including notes, loans, lease purchase contracts, lines of credit, and commercial paper.

TAX-EXEMPT CONDUIT BONDS

Conduit bonds are tax-exempt bonds issued by a state or local government, whereby the proceeds are generally used to make or finance a loan to an entity other than a state or local government. Certain conduit bonds are issued for the purpose of making loans to other local governments. Bonds that are issued for the purpose of making loans to other entities are commonly referred to as “conduit bonds” or “conduit issues,” and state or local governments which issue these bonds are commonly referred to as “conduit issuers.” To be tax exempt, conduit bonds, like any other bonds, must be either purely governmental bonds or be qualified bonds, as defined in section 141(e) of the Code (e.g., exempt facility bonds, qualified small issue bonds, or qualified 501(c)(3) bonds), and are not arbitrage bonds within the meaning of section 148 of the Code.

The federal tax compliance rules covered in this publication are those that are the responsibility of the conduit issuer. Recent legislation has expanded the types of tax-advantaged conduit bonds including various tax credit bonds enacted as part of the American Recovery and Reinvestment Act of 2009.

In order to comply with these requirements, conduit issuers must ensure that certain rules are met at the time the conduit bonds are issued and that others are met throughout the term of the conduit bonds. The IRS encourages conduit issuers of tax-exempt bonds to implement procedures that will enable them to adequately safeguard against violations that result in loss of the tax-exempt status of their bonds.

PARTIES TO CONDUIT BOND ISSUE

An issuer of conduit bonds is generally not obligated to pay debt service on the conduit bonds from its revenues -- the true obligor is the conduit borrower. The conduit issuer is not directly receiving the tax benefits relating to the conduit bonds. However, the

conduit issuer is treated as the “taxpayer” for certain federal income tax purposes and procedures.

A conduit borrower is generally responsible for the payment of debt service on the conduit bonds and is often contractually obligated to maintain the tax status of the bonds.

The bondholder receives the tax benefits and bears the tax liability if there is a failure to meet the requirements of the Code applicable to maintain the tax status of the bonds. The bondholder relies on the conduit issuer and the conduit borrower to maintain the tax status of the bonds.

In general, the conduit issuer and the conduit borrower are responsible for tax compliance. The division of responsibility, between the parties to maintain compliance, is defined in the bond documents for the particular bond issue.

The first part of this publication sets forth the minimum required role of the conduit issuer in a conduit financing. The second part of this publication discusses certain policy considerations which should be considered by the conduit issuer when formulating it tax compliance policy. A conduit issuer has a minimum required role on or before the date of issuance of the conduit bond as well as a continuing minimum compliance role after the issuance of the conduit bonds.

BONDS SUPPORTED BY TRUE LEASES

Certain bonds issued by state or local governments are not used to make loans to other entities. Nevertheless, such issues (e.g., certain airport bonds) may be used to finance facility leases to another entity for the entire term of the bonds. While such issues are not conduit bonds, the lessee of such facilities often is responsible for many of the compliance requirements, and such bonds may be treated as conduit bonds for many purposes. Accordingly, many of the issues described herein apply to issuers of such bonds.

MINIMUM REQUIRED ROLE FOR A CONDUIT ISSUER

The following is a discussion of the minimum required role of the conduit issuer in the financing of conduit bonds. The provisions discussed herein do not generally require a conduit issuer to monitor or assure compliance with the federal income tax eligibility requirements that apply to a conduit bond issue, but do require a conduit issuer to take a number of specific actions.

Information Filing Requirements – At the time of issuance, conduit issuers must comply with certain information filing requirements under sections 149(e) and 54A(d)(3) of the Code. The information return that an issuer is required to file is dictated by the size and/or type of conduit issuance.

Information Return	Due Dates	Where to File
Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues.* Download Form 8038 at www.irs.gov/app/picklist/ list/formsInstructions.html	Generally, this return is required to be filed by the 15th day of the second calendar month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on Feb 1 is May 15.	**File these returns with the IRS at the following address:** **Internal Revenue Service Center** **Ogden, UT 84201**
Form 8038-G, *Information Return for Tax-Exempt Governmental Obligations*, for governmental bonds with an **issue price of $100,000 or greater.** *Form 8038-GC, Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales*, for govern-mental bonds with **an issue price of less than $100,000.** Download Forms 8038-G and 8038-GC at www.irs.gov/app/picklist/ list/formsInstructions.html	Generally, both of these returns are required to be filed by the 15th day of the second calendar month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on Feb 15 is May 15. Form 8038-GC may, however, also be filed on a consolidated basis for bond issues of less than $100,000 each. Consolidated returns are due by Feb 15th following the calendar year in which the bonds were issued. Example: An issuer issues three governmental bond issues as follows: Issue A issued on 3/1/10 for an issue price of $50,000; Issue B on 6/15/10 for $75,000; and Issue C on 10/5/10 for $30,000. Issuer can file one consolidated return by Feb 15, 2011, for all three bond issues.	**File these returns with the IRS at the following address:** **Internal Revenue Service Center** **Ogden, UT 84201**
Form 8038-TC, Information Return for Tax Credit Bonds and Specified Tax Credit Bonds. Download Form 8038-TC at www.irs.gov/app/picklist/ list/formsInstructions.html.	Generally, this return is required to be filed by the 15th day of the second calendar month following the quarter in which the bonds were issued. For example, the due date of the return for bonds issued on Feb 1 is May 15.	**File these returns with the IRS at the following address:** **Internal Revenue Service Center** **Ogden, UT 84201**

Requesting an Extension of Time to File – A conduit issuer may request an extension of time to file Forms 8038-G, 8038-GC, 8038-TC, or 8038, as applicable, so long as the failure to file the return on time was not due to willful neglect. To request an extension, the conduit issuer must follow the procedures outlined in Revenue Procedure 2002-48, 2002-37 I.R.B. 531, published September 16, 2002. These procedures generally require that the issuer: 1) attach a letter to Form 8038-G, Form 8038-GC, 8038-TC, or 8038, as applicable, briefly explaining when the return was required to be filed, why the return was not timely submitted, and whether or not the bond issue is under examination; 2) enter on top of the letter "Request for Relief under Section 3 of Revenue Procedure 2002-48;" and 3) file this letter and the return with the IRS at the Ogden Submission Processing Center.

Volume Cap Limit – The volume cap limit for certain qualified private activity bonds, as set forth in section 146 of the Code, limits an issuing authority to a maximum amount of tax-exempt bonds that can be issued to finance a particular qualified purpose during a calendar year. If, during a given year, an issuing authority issues qualified private activity bonds in excess of its applicable volume cap limit, the tax-exempt status of those bonds is jeopardized. As such, section 146 of the Code implies that a conduit issuer has an obligation to monitor volume cap allocations; however, there are no specific procedures or requirements for monitoring, other than procedures for filing information returns and making carryforward elections.

Certain types of qualified private activity bonds, including qualified 501(c)(3) bonds and exempt facility bonds to finance governmentally-owned airports, docks and wharves, do not require volume cap allocations. In addition, certain refunding bonds that do not extend weighted average maturity do not require volume cap allocations.

Carryforward of Unused Volume Cap – An issuing authority may elect to carry any unused volume cap of a calendar year forward for three years. This election can be made for each of the qualified private activity bond purposes subject to volume cap except for the purpose of issuing qualified small issue bonds. This election is made by filing IRS Form 8328, *Carryforward Election of Unused Private Activity Bond Volume Cap*, by the earlier of February 15th following the year in which the unused amount arises or the date of issue of bonds pursuant to the carryforward election. Once Form 8328 is filed, the issuer may not revoke the carryforward election or amend the carryforward amounts shown on the form. Download IRS Form 8328 at **www.irs.gov/app/picklist/list/formsInstructions.html**.

Public Approval Requirement – Generally, prior to issuance, qualified private activity bonds (including qualified 501(c)(3) bonds) must be approved by the governmental entity issuing the bonds and, in some cases, each governmental entity having jurisdiction over the area in which the bond-financed facility is to be located. Public approval is a process consisting of: the provision of reasonable public notice in advance for a public hearing; holding of a public hearing; and the public approval by applicable governmental official(s) within a prescribed period. As such, the conduit issuer must be involved in certain aspects of the public approval process. Public approval by a governmental unit(s) may also be by voter referendum. Section 147(f) of

the Code and section 5f.103-2 of the Treasury regulations define the specific rules for this requirement.

Limitations Relating to Fees Charged by the Conduit Issuer – Conduit issuers may charge fees payable either out of the bond proceeds or by the conduit borrower. Such fees may be used by the conduit issuer to offset all or a portion of the costs payable by the issuer related to its role and may also be used to raise funds for governmental purposes of the conduit issuer. Such fees may increase the effective yield of the conduit loan when viewed by the issuer as a purpose investment. Section 148 of the Code generally limits the yield on purpose investments to the yield on the bonds plus a spread. This limitation effectively limits the size of the fees that may be charged by the conduit issuer regardless of whether paid periodically or up front. Conduit issuers generally adopt policies that assure that the yield on the conduit loan does not exceed the yield on the bonds by more than the permitted spread.

Certification Regarding Expectations for Use and Investment of Proceeds – The regulations generally require a conduit issuer to make a certification regarding its expectations in the following manner:

> An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's reasonable expectations as of the issue date. The certification must state the facts and estimates that form the basis of the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.[1]

This certification is not required if the issuer reasonably expects, as of the issue date, that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund or the issue price of the bond issue does not exceed $1,000,000.

Reimbursement Declarations of Intent – Under regulations that generally apply to tax-exempt bonds and tax credit bonds, an issuer or conduit borrower is permitted to use bond proceeds to reimburse certain expenditures paid before the date of issuance subject to certain requirements. One requirement is that the issuer must adopt a declaration of intent to reimburse expenditures not later than 60 days after the reimbursed expenditure is paid. In the case of qualified 501(c)(3) bonds only, a conduit borrower may adopt a declaration of intent. Accordingly, for all types of qualified private activity bonds (and tax credit bonds that are similar to qualified private activity bonds) the conduit issuer must act to adopt declarations of intent to permit reimbursement financing.

[1] Treas. Reg. §1.148-2(b)(2)(i).

Qualified Hedge – A conduit issuer must identify a hedge on its books and records maintained for the hedged bonds not later than three (3) days after the date on which the conduit issuer (or conduit borrower) and the hedge provider enter into a hedge contract.

Deliberate Actions – Conduit bonds can lose their tax-exempt status if the conduit issuer or conduit borrower takes a deliberate action, subsequent to the issue date, that causes the issue to become a non-qualifying private activity bond issue. A deliberate action is any action taken by the conduit issuer or conduit borrower that is within its control. Intent to violate the requirements of section 141 of the Code is not necessary for an action to be deliberate.

Remedial Actions/Reissuance – A conduit issuer, often with the involvement of the conduit borrower, may take a remedial action prescribed in section 1.141-12 of the Treasury regulations to cure a deliberate action that would otherwise cause a governmental bond issue to become a non-qualified private activity bond issue. In most cases, the conduit issuer is not required to be involved in the remedial action. However, if the remedial action requires providing a notice of defeasance to the Internal Revenue Service, such notice must be provided by the conduit issuer. Additionally, if the bonds are treated as "reissued" under Treasury regulations, the conduit issuer must sign and file the applicable Form 8038. Remedial actions include redemption or defeasance of bonds, alternative use of disposition proceeds, and alternative use of bond-financed facilities.

Bond Modifications – An agreement between a bondholder and a conduit borrower to modify the terms of bonds, whether direct or indirect, may cause the modified bonds to be treated as new bonds for federal income tax purpose (that is, to be "reissued"). If the conduit bond is considered reissued, then in general the conduit bond must be tested to determine if the interest on the bonds remains exempt from gross income for federal income tax purposes. Rev. Rul. 81-281 holds in general that interest on tax-exempt conduit bonds is not excludable from gross income after the terms of the bonds are substantially altered without action by the state or local government issuer. In general, a conduit issuer may meet this requirement to approve reissued bonds by filing a timely Form 8038 treating the date of the modification as the date of issuance of the modified bonds.

Elections – The arbitrage regulations set forth the following general rule for making elections:

> Except as otherwise provided, any required elections must be made in writing and, once made, may not be revoked without the permission of the Commissioner.[2]

The private activity bond regulations set forth the following comparable rule for elections:

[2] Treas. Reg. §§1.141-1(c) and 1.148-1(d).

> Elections must be made in writing on or before the issue date and retained as part of the bond documents and, once made, may not be revoked without the permission of the Commissioner.[3]

The following elections, if made, must be made by a conduit issuer under these regulations:

> i. Election to waive the right to treat a purpose investment as a program investment.[4]
> ii. Election to waive the right to invest in higher yielding investments during any temporary period.[5]
> iii. Election of the issuer of a pooled financing issue to apply rebate spending exceptions separately to each conduit loan.[6]
> iv. Election for purposes of the two-year spending exception from rebate to apply certain provisions based on actual facts rather than reasonable expectations.[7]
> v. Election for purposes of the two-year spending exception from rebate to exclude, from available construction proceeds the earnings on a reasonably required reserve or replacement fund.[8]
> vi. Election for purposes of the two-year spending exception to treat a portion of an issue as a separate construction issue from rebate.[9]
> vii. Election to pay one and one-half percent penalty in lieu of arbitrage rebate.[10]
> viii. Election to treat portions of a bond issue as separate issues.[11]

Arbitrage Rebate Requirements/Yield Reduction Payments – The rebate requirements of section 148(f) of the Code generally provide that, unless certain earnings on nonpurpose investments allocable to the gross proceeds of an issue are paid to the U.S. Department of the Treasury, the bonds in issue will be arbitrage bonds. The arbitrage that must be rebated is based on the excess (if any) of the amount actually earned on nonpurpose investments over the amount that would have been earned if those investments had a yield equal to the yield on the issue, plus any income attributable to such excess. Under section 1.148-3(b) of the Treasury regulations, the

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[3] Treas. Reg. §1.141-1(c).
[4] Treas. Reg. §1.148-2(h).
[5] Treas. Reg. §1.148-2(h).
[6] Treas. Reg. §1.148-7(b)(6).
[7] Treas. Reg. §1.148-7(f)(2).
[8] Treas. Reg. §1.148-7(i)(2).
[9] Treas. Reg. §1.148-7(j).
[10] Treas. Reg. §1.148-7(k) and section 148(f)(4)(C)(vii) of the Code.
[11] Treas. Reg. §1.150-1(c)(3).

future values (as of the computation date) of all earnings received and payments made, with respect to nonpurpose investments, are included in determining the amount of rebate due. There are, however, two broad exceptions to the general rebate requirements applicable to governmental bonds: the small issuer exception; and the spending exceptions.

In certain circumstances, the Treasury regulations permit the conduit issuer to make payments to the U. S. Department of the Treasury in lieu of restricting the yield on investments made with bond proceeds at the end of a temporary period.

Conduit issuers of tax-exempt bonds file IRS Form 8038-T; *Arbitrage Rebate and Penalty in Lieu of Arbitrage Rebate*, to make the following types of arbitrage payments: 1) yield reduction payments; 2) arbitrage rebate payments; 3) penalty in lieu of rebate payments; 4) the termination of the election to pay a penalty in lieu of rebate; and 5) penalty for failure to pay arbitrage rebate on time. Download this form and instructions at www.irs.gov/app/picklist/list/formsInstructions.html.

A yield reduction payment and/or arbitrage rebate installment payment is required to be paid no later than 60 days after the end of every 5th bond year throughout the term of a bond issue. The payment must be equal to at least 90% of the amount due as of the end of that 5th bond year. Upon redemption of a bond issue, a payment of 100% of the amount due must be paid no later than 60 days after the discharge date.

A failure to timely pay arbitrage rebate will be treated as not having occurred if the failure is not due to willful neglect and the conduit issuer submits a Form 8038-T with a payment of the rebate amount owed, plus penalty and interest. The penalty may be waived under certain circumstances. For more information, see section 1.148-3(h)(3) of the Treasury regulations.

In general, a request for recovery of overpayment of arbitrage rebate can be made when the conduit issuer can establish that an overpayment occurred. An overpayment is the excess of the amount paid to the U.S. Department of the Treasury for an issue under section 148 of the Code over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested. The request can be made by completing and filing IRS Form 8038-R, *Request for Recovery of Overpayments Under Arbitrage Rebate Provisions*, with the IRS. Download this form at www.irs.gov/app/picklist/list/formsInstructions.html.

IRS Examination of Conduit Issues – The Tax Exempt Bond administrative procedures provide that the conduit issuer, and not the conduit borrower, will be treated as the "taxpayer" in IRS examinations of tax-exempt bonds, including conduit bonds. This means that the conduit issuer will receive the letter initiating the examination, and needs to be a party to any closing agreement resolving the IRS' examination.

Requesting Voluntary Closing Agreements (VCAP) – In Notice 2001-60, 2001-40 I.R.B. 304, published October 1, 2001, the IRS announced the TEB Voluntary Closing

Agreement Program ("VCAP"). Notice 2008-31 (which modifies and supersedes Notice 2001-40) provides information about VCAP for tax-exempt bonds and tax credit bonds. This program provides remedies for issuers, including conduit issuers, who voluntarily come forward to resolve a violation. Closing agreement terms and amounts may vary according to the degree of violation as well as the facts and circumstances surrounding the violation.

This notice and Internal Revenue Manual provisions referenced by the notice, generally contemplate that the conduit issuer must request and execute a voluntary closing agreement.

Requests for VCAP closing agreements are administered by the TEB Compliance and Program Management staff to encourage issuers and other parties to voluntarily come to the IRS to resolve problems, VCAP permits a conduit issuer or its representative to initiate preliminary discussions of a closing agreement anonymously. Additional information regarding VCAP is available in Notice 2008-31 and Section 7.2.3 of the Internal Revenue Manual. These documents are available through our Web site at *www.irs.gov/bonds*.

The IRS has released detailed Tax Exempt Bond administrative procedures under Section 4.81.1 of the Internal Revenue Manual. These administrative procedures generally define the "issuer" as "the state or political subdivision or entity that issues bonds on behalf of a state or local government."

Requesting Private Letter Rulings – Revenue Procedure 96-16 sets forth required procedures under which an issuer of tax-exempt bonds, including a conduit issuer, can request a private letter ruling. Separate procedures apply to "reviewable" private letter ruling requests under section 7478 of the Code and to "nonreviewable" private letter ruling requests. Under section 7478 of the Code, an issuer may appeal the denial of a private letter ruling to the United States Tax Court. The revenue procedure generally requires that, in the case of the conduit issue, the private letter ruling request must be submitted by the conduit issuer, rather than the conduit borrower.[12]

TEB Information and Services – The office of Tax Exempt Bonds (TEB) offers information and services through its voluntary compliance programs -- (including the Voluntary Closing Agreement Program) and its education and outreach programs. You can learn about these programs through our Web site at ***www.irs.gov/bonds***.

Customer Education and Outreach – TEB has reading materials about the tax laws applicable to municipal financing arrangements, tax forms and instructions, revenue procedures and notices, and TEB publications available on our Web site at ***www.irs.gov/bonds***. For personal assistance, you can contact TEB directly at (202) 283-2999, or call our Customer Account Services toll-free at (877) 829-5500, Monday through Friday, 8:00 a.m. — 6:30 p.m. EST.

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[12] Rev. Prov. 96-16 also contemplates that a bondholder may submit a nonreviewable request for a private letter ruling. The wording of section 7478 of the Code does not expressly require that a reviewable request must be submitted by a conduit issuer.

CERTAIN POLICY AND PROCEDURAL OPTIONS FOR CONDUIT ISSUERS

The first part of this publication discussed the minimum required role for a conduit issuer. The second part of this publication discusses policies and procedures for a conduit issuer to consider adopting with respect to its conduit bond program even though the IRS does not require a conduit issuer to do so.

Designation of Officials to take Post-Issuance Actions – Other than the statutory requirement that an "applicable elected representative" must provide public approval, the provisions of the Code, regulations or other guidance specifically provide that particular officials of a conduit issuer have specific tax compliance responsibilities. As discussed in the first part of this publication, the regulations and the IRS' other guidance and procedures require that a conduit issuer must be involved in a number of different actions taken after the date of issuance of a bond issue, including: (1) responding to an examination of the bond issue by the IRS; (2) submitting a voluntary closing agreement request to the IRS; (3) submitting a private letter ruling request to the IRS; (4) implementing a "remedial action" upon the change of use of bond-financed property, including, where necessary, filing a supplemental Form 8038 and filing a notice of defeasance; (5) executing a "hedge identification" permitting an interest rate swap or other interest rate hedge to be taken into account in determining bond yield; and (6) approving a modification of the terms of the bonds in cases where a modification results in a "reissuance" for federal income tax purposes.

A conduit issuer should consider whether to designate one or more officials, on a standing basis, to be responsible for taking such actions after the date of issuance of a conduit bond issue.

Post-Issuance Compliance – There are certain core elements of reasonable bond compliance procedures that should be considered by a conduit issuer for adoption and implementation to demonstrate a favorable record retention policy. These core elements are: (1) reasonable procedures for assignment of compliance responsibilities; (2) reasonable procedures for the establishment and maintenance of books and records; (3) reasonable procedures for compliant investment of gross proceeds; (4) reasonable procedures for the review and allocation of bond proceeds; (5) reasonable procedures for periodic monitoring of use of financed property; and (6) reasonable susceptibility to audit.

A "one size fits all" approach is not workable, and a conduit issuer should consider tailoring its procedures in order to meet these core elements.

A conduit issuer should consider whether to include specific references to some or all of these core elements in its compliance procedures.

i. Designation of Compliance Responsibilities

The policy options for a conduit issuer relating to designation of compliance responsibilities include whether to: (1) provide that the conduit issuer is responsible for any compliance responsibilities after the date of issuance; (2) designate a particular conduit issuer official or officials responsible for post-issuance compliance; and (3) require conduit borrowers to identify a particular official or officials responsible for post-issuance compliance.

ii. Adoption of Policies and Procedures by Conduit Borrowers

The policy options for a conduit issuer relating to adoption of policies and procedures by conduit borrowers include: (1) whether to require the conduit borrower to demonstrate that it has adopted written post-issuance compliance procedures before the approval of a bond issue; and (2) if the conduit issuer requires conduit borrowers to adopt written compliance procedures, whether those procedures must contain certain fundamental elements.

iii. Rebate and Yield Restriction Compliance

The policy options of a conduit issuer relating to rebate and yield restriction compliance include: (1) whether the conduit issuer should delegate to the conduit borrower the ability to invest bond proceeds, or whether the conduit issuer should invest bond proceeds; (2) whether the conduit issuer should delegate the responsibility to the conduit borrower to comply with rebate and arbitrage requirements; (3) whether the conduit issuer should approve the rebate service provider retained by the conduit borrower; and (4) what limitations the conduit issuer imposes on its own fees charged to the conduit borrower.

iv. Expenditure of bond proceeds

The policy options of a conduit issuer relating to expenditure of bond proceeds include: (1) whether the conduit issuer should delegate to the conduit borrower the ability to determine how bond proceeds are spent and the responsibility to ensure that all expenditures are compliant; (2) whether the conduit issuer should approve expenditures, either in a final review or otherwise; and (3) if the conduit issuer does not approve expenditures, whether the conduit issuer should require the conduit borrower to provide certifications of expenditures, either in the form of a final bond proceeds allocation certificate or otherwise.

v. Change of Use and Remedial Actions

The Treasury regulations provide for a number of “remedial actions” that may be taken to preserve the qualification of a bond issue in cases where a “change of use” of the financed property results in noncompliance with requirements relating to use of bond proceeds. For example, in the case of qualified 501(c)(3) bonds, the following

types of remedial actions may be available: redemption or defeasance of nonqualified bonds[13]; alternative use of disposition proceeds received from the sale for cash of bond-financed property[14]; and alternative qualifying use of a facility.[15] Under the Treasury regulations, the conduit issuer is required to participate in some, but not all, of these remedial actions. For example, in the case of a remedial action involving the redemption of nonqualified bonds within ninety (90) days of a deliberate action resulting in noncompliance, no participation by the conduit issuer is required. In the case of a remedial action involving the defeasance of bonds which cannot be redeemed within ninety (90) days of the deliberate action resulting in noncompliance, participation by the conduit issuer is required, because the conduit issuer must execute and file a notice of defeasance with the IRS. In the case of a remedial action involving alternative qualifying use of disposition proceeds, participation by the conduit issuer is required, because the conduit issuer must execute and file a supplemental Form 8038, and may be required, depending on the facts and circumstances, to provide a new public approval of the facilities to be financed with disposition proceeds.

A number of detailed requirements must be met in the case of each remedial action.

Accordingly, the policy options for a conduit issuer relating to remedial actions include: (1) whether to require the conduit borrower to include the participation and approval of the conduit issuer in all remedial actions, even in those cases where the tax regulations do not require conduit issuer participation; and (2) whether to require a bond counsel opinion relating to all or some types of remedial actions.

vi. Record Retention

The policy options for a conduit issuer relating to record retention requirements include: (1) whether to specifically designate which types of records must be retained by conduit issuers and which types of records, if any, will be retained by the conduit issuer; and (2) whether to identify a specific period during which records must be retained (for example, three years after the April 15 of the calendar year immediately following the retirement of the last bond of an issue).

Policies Relating to Safe Harbors – Regulations and published rulings set forth a number of safe harbors under which a bond issue is conclusively or rebuttably treated as meeting a tax-exempt bond eligibility requirement. These safe harbors include: (1) the safe harbor for purchase of guaranteed investment contracts and yield restricted defeasance escrows, under which a specified “three-bid” procedure may establish fair market value[16]; and (2) the safe harbor for the amount of broker’s commissions and

[13] Treas. Reg. 1.141-12(d).

[14] Treas. Reg. 1.141-12(e).

[15] Treas. Reg. 1.141-12(f).

[16] Treas. Reg. 1.148-5(d)(3).

other similar costs relating to the purchase of guaranteed investment contracts and yield restricted defeasance escrows may be treated as part of the cost of the investment.[17]

The policy options for a conduit issuer relating to such safe harbors include: (1) whether to require compliance with such safe harbors unless an opinion of counsel or other acceptable indication of compliance is provided; and (2) whether to require notification to the issuer of situations under which certain safe harbor requirements are not met.

Policies relating to issuance of extraterritorial bond issues – Other than the statutory requirement that a bond issue receive both "issuer approval" and "host approval" in the case of bonds that finance a facility located outside of the jurisdiction of the issuer, the Service has not provided guidance on appropriate procedures for extraterritorial bond issues. The policy options for a state or local government acting as the issuer of such an extraterritorial issue, however, include: (1) whether to adopt policies specifying the nature and extent of the relationship of the conduit borrower or the extraterritorial financed facility to the issuer (for example, a requirement that the conduit borrower conduct operations within the jurisdiction of the issuer); and (2) whether to adopt procedures that provide for notifying the host jurisdiction of any post-issuance events (for example, an examination of the bond issue).

Policies relating to providing "host approval" – The Service has not identified any compliance or oversight role for a state or local government providing "host approval" of a bond issue for purposes of the statutory public approval requirement. The policy options for a state or local government providing "host approval," however, include: (1) whether to require representations or assurances that the issuing jurisdiction has adopted compliance policies or procedures (for example, a policy requiring that the conduit borrower has adopted and implemented post-issuance compliance procedures); (2) whether to require the issuing jurisdiction to provide notification to the host jurisdiction of any administrative contacts with the Service after the date of issuance (for example, notification of examinations and voluntary closing agreement requests); and (3) whether to require the issuing jurisdiction to provide notification to the host jurisdiction of any change of use of the property financed with the bonds, within or outside of the host jurisdiction.

Policies relating to composite bond issues – Under certain circumstances, bonds issued by two or more conduit issuers may be treated as part of the same "issue" for purposes of the tax-exempt bond eligibility requirements. In general, in such cases, a compliance problem relating to bonds issued by one conduit issuer could cause the bonds of all of the conduit issuers to fail to meet the applicable tax-exempt bond requirements. The policy options for an issuer of a composite bond issue include: (1) whether to require representations or assurances that the other conduit issuers of the composite issue have adopted compliance policies for procedures; (2) whether to require the other conduit issuers of the composite issue to provide notification to the

[17] Treas. Reg. 1.148-5(e)(2)(iii).

conduit issuer of any administrative contacts with the Service after the date of issuance; (3) whether to require the other conduit issuers to provide notification to the conduit issuer of any change of use of the property financed with the composite issue bonds; and (4) whether to require that a "multipurpose allocation" be made with respect to the conduit bond issue for purposes of the requirements relating to use of financed property so that a compliance problem relating to use of financed property financed by bonds of another conduit issuer will not necessarily cause the bonds of the conduit issuer to fail to qualify as tax-exempt.

Procedures relating to responding to an IRS bond examination – Current procedures of the Service treat the conduit issuer as the "taxpayer" in an examination. The policy options for a conduit issuer relating to bond examinations include: (1) whether the conduit issuer should adopt a standing procedure or policy identifying a particular official or officials who have responsibility for responding to bond examinations by the Service; (2) whether the conduit issuer should directly handle the examination, or assign to the conduit borrower responsibilities for handling the examination; (3) whether the conduit issuer should retain its own counsel to respond to a bond examination; (4) whether the conduit issuer should permit the bond counsel firm that rendered the approving opinion to represent the conduit issuer in the examination; and (5) whether the conduit issuer should permit a single counsel to represent both the conduit issuer and the conduit borrower in the examination.

Procedures relating to seeking a voluntary closing agreement – Current procedures of the Service treat the conduit issuer as the "taxpayer" in a voluntary closing agreement request. The policy options for a conduit issuer relating to voluntary closing agreement requests include: (1) whether the conduit issuer should adopt a standing procedure or policy identifying a particular official or officials who have responsibility for participating in such requests; (2) whether the conduit issuer should retain its own counsel in connection with such a request; and (3) whether the conduit issuer should permit a single counsel to represent both the conduit issuer and the conduit borrower in such a request.

Policies relating to potential conflicts of interest – Attorneys representing conduit issuers and conduit borrowers are subject to conflict of interest rules under state law and Circular 230. The participation of two different "issuers" in conduit issues raises a host of possible conflict of interest questions. The policy options for a conduit issuer relating to dealing with such conflict of interest questions include: (1) whether to permit a single counsel to represent the conduit issuer and the conduit borrower in an examination of a bond issue; and (2) whether to permit a single counsel to represent the conduit issuer and the conduit borrower in a voluntary closing agreement request.

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Federal, State and Local Governments: Review of the Government Accountability Office (GAO) Report to Congressional Requesters Entitled "Social Security Administration – Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees"

Maryann Motza, Project Leader

Patricia Phillips

Paul Carlson

June 15, 2011

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Table of Contents

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I. Executive Summary

A. Overview of Report

The principal goal of this project undertaken during 2010-2011 by the Federal, State and Local Governments (FSLG) Subcommittee of the Internal Revenue Service's (IRS) Advisory Committee on Tax Exempt and Government Entities (TE/GE) (ACT) was to review and comment on the Government Accountability Office (GAO) Report to Congressional Requesters entitled "Social Security Administration: Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees"[1] (hereinafter referred to as "GAO report") that was issued in September 2010. The ACT's review of the GAO report focused on providing feedback and recommendations that will aide FSLG in improving the IRS's organizational focus and service level to state and local government employers and employees.

B. Principles

The ACT adhered to the following principles while completing this project:

1. The stakeholder feedback and recommendations to the IRS about the GAO report will have a positive impact on taxpayers.

2. Recommendations contained in this report are consistent with the ACT Charter[2] which states, in pertinent part:

> "Objective and Scope. The ACT is established to provide an organized public forum for discussion of relevant employee plans, exempt organizations, tax-exempt bond, and federal, state, local and Indian tribal government issues between officials of the Internal Revenue Service (IRS) and representatives of the employee plans, exempt organizations, tax-exempt bond, and federal, state, local and Indian tribal government communities; and to enable the IRS to receive regular input with respect to the development and implementation of tax administration issues affecting those communities. The ACT members will present, in an organized and constructive fashion, the interested public's observations about current or proposed Tax Exempt and Government Entities division programs and procedures and will suggest improvements."

[1] Government Accountability Report Number GAO-10-938 (referred to throughout this ACT report as "GAO report"), is available at: http://www.gao.gov/new.items/d10938.pdf or http://www.gao.gov/htext/d10938.html (for accessible text).

[2] Charter for the Advisory Committee on Tax Exempt and Government Entities of the Internal Revenue Service, June 16, 2009.

3. The recommendations support the FSLG FY 2011 Work Plan, issued October 1, 2010, which states, in pertinent part:

> "FSLG's primary objective is to promote compliance with employment tax withholding/reporting and information reporting requirements by governmental units and their subordinate agencies. FSLG is also responsible for ensuring compliance with, and assisting in, the administration of FICA coverage agreements under the provisions of Section 218 of the Social Security Act.
>
> "In FY 2011, FSLG will continue to maintain an effective balance between traditional compliance work and educational activities.
>
> "[FSLG] supports the Internal Revenue Service (IRS) and the Tax Exempt and Government Entities (TE/GE) division strategic goals:
> 1) Improve customer service to make voluntary compliance easier; and
> 2) Enforce the law to ensure everyone meets their obligation to pay taxes.
> . . .
> "In FY 2011, FSLG will devote resources to projects to improve employee knowledge and our customer service level in several critical areas: international compliance, identification and development of fraud, the Section 218 arena, and government plans."[3]

4. The GAO report discussed at length the interrelated nature of responsibilities that the IRS shares with both the U.S. Social Security Administration (SSA) and State Social Security Administrators (State Administrators) associated with Social Security and Medicare coverage and employment taxes for state and local government employers and employees. It also encouraged the IRS and SSA to work closely with NCSSSA and the State Administrators:

> "SSA and IRS do not currently have the information needed and procedures in place to effectively and efficiently provide oversight of Social Security coverage for public employees. When IRS began collecting and overseeing the accuracy of the taxes collected in 1987, SSA ceased key monitoring activities that could help ensure states and public employers are following the states' agreements for Social Security coverage. Ensuring the accuracy of the Social Security records for public employees is still a requirement for SSA, and should be a priority for the managers of SSA and IRS. At present, SSA and IRS managers do not know the extent to which wages are reported accurately or to which Social Security taxes are paid in accordance with program rules. States can also play a vital role in the oversight structure of Social Security coverage for public employees, but lack clear guidelines with specific responsibilities to ensure state participation. Absent additional management attention and a system to monitor the accuracy of public employer wage reporting, Social Security benefits, and tax payments may be

[3] FY 2011 Federal, State and Local Governments Work Plan (October 1, 2010): http://www.irs.gov/pub/irs-tege/fslg_fy11_work_plan.pdf .

> inaccurately reported. Without a coordinated monitoring process between SSA and IRS to make sure that public employers are complying with state coverage agreements, opportunities to identify and correct errors will be lost. Given the projected fiscal challenges of the Social Security program in the coming decades, every attempt should be made to assure coverage is correctly applied so that employers and employees are reporting earnings and paying taxes when required to do so."[4]

Given the nature and scope of the GAO report and the unique interrelationship of responsibilities of the IRS, SSA, and State Administrators, it is impossible to properly analyze the GAO report and provide meaningful advice to the IRS without also discussing some issues that are outside the jurisdiction of the IRS.

Both the SSA and State Administrators have integral roles to play[5] in ensuring public employer (state and local governments) compliance with FICA taxes; Social Security and Medicare coverage and benefits (both voluntary Section 218 Agreement and mandatory Social Security and Medicare coverage); independent contractor reporting, such as Form 1099 filings; worker classification matters; public retirement system requirements; and other tax and coverage-related issues.

The ACT members understand, and appreciate, that comments about both SSA and State Administrators are not advisory in nature, but are solely included for explanatory and clarifying purposes with this report and its recommendations to the IRS.

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[4] GAO Report (GAO-10-938), p. 32.

[5] See Chapters 8, 9, and 10 in the *Federal-State Reference Guide* (IRS Publication 963) at http://www.irs.gov/pub/irs-pdf/p963.pdf for details on the roles and responsibilities of SSA and State Administrators vis-à-vis state and local governments' compliance with the United States Internal Revenue Code and United States Social Security Act and associated regulations and policies.

C. Recommendations

The ACT's recommendations to the IRS, based on our analysis of the GAO report, fall into four major categories:

1. **Improve information sharing by the IRS/FSLG with both SSA and State Administrators.**

   Based on a detailed analysis of the GAO report related to state and local government employees, the ACT finds that the IRS/FSLG office within the Tax Exempt and Government Entities division can improve its efficiency and effectiveness in tax administration activities associated with state and local governments' FICA tax and public pension system compliance by improving information sharing with both the U.S. Social Security Administration and State Social Security Administrators. Unfortunately, as the GAO report noted in numerous instances, the IRS is limited in the information it can share with both the SSA and the states. Ironically, the only two parties to the voluntary Social Security and Medicare coverage agreements (i.e., Section 218 Agreements) are the states and SSA, yet those are the exact governmental agencies with whom the IRS cannot share information. Improving the information sharing between the IRS and State Administrators would result in the IRS being better able to accurately determine the proper employment tax assessment applicable to a particular state or local government (public) employer.

   The Congressional requesters of the GAO report did not ask the GAO to examine the impact of Internal Revenue Code (IRC) Section 6103 on the management and administration of the Social Security and Medicare coverage and benefits of public employees, public pension system requirements, and FICA tax compliance by public employers. Despite that fact, however, the inability of the IRS to share information not only with State Administrators but also with the Social Security Administration due to existing federal law are reflected throughout the GAO report.

   The ACT recommends that the IRS contact State Administrators in each state prior to conducting compliance checks and examinations to verify the coverage applicable to each public employer/employee. The IRS should use any and all powers or authorities to secure Section 218 Agreements and modifications and related entity information from the State Administrator as a normal course of business. According to information provided to the ACT by NCSSSA, however, Treasury Counsel and the IRS have stated that Congressional action is necessary to change 26 IRC §6103, before the IRS can formally involve State Administrators in such discussions.

   General information, including copies of the state's Section 218 Agreement and modifications to that agreement are requested by the IRS, and provided by the State Administrator. When conducting compliance checks or examinations, however, the IRS cannot communicate with State Administrators unless the public employer authorizes them to do so. The current process used by the IRS whereby the IRS is

given permission to share taxpayer information with the State Administrator, i.e., Form 8821, is rarely used anywhere in the country and, where it has been used, there is little empirical evidence that it has assisted the IRS in any meaningful fashion.

Disclosure restrictions imposed by IRC Section 6103 limit the IRS's ability to share valuable and pertinent information with State Social Security Administrators (State Administrators). The effect is two-fold:

A. Since 1987, when the IRS assumed responsibility for collecting FICA taxes from state and local governments (public employers), State Administrators have not been privy to information related to tax compliance by public employers in their states. The lack of that information impairs the State Administrators' ability to properly administer their state's Section 218 (voluntary coverage) Agreements with the U.S. Social Security Administrator. It impairs the obligation of the contract in that it unduly restricts the states' ability to perform its duties under the agreement between the individual state and the federal government.[6]

B. IRS FSLG Specialists, without the information held (sometimes solely) by State Social Security Administrators, are unduly hampered in making tax determinations which may result in some erroneous taxation and coverage decisions. The reason is, due to IRC Section 6103 disclosure restrictions, the IRS cannot confer with State Administrators about public employers' FICA, public pension systems, and Social Security/Medicare coverage obligations. The State Administrators' records contain critical information that can, and should, be accessed by the IRS before a compliance check or examination is conducted on a public employer.[7]

Is changing IRC Section 6103 the panacea to solve all employment tax and Social Security/Medicare coverage issues for all public employers? Certainly not, but it will do no harm (because it's all government-to-government exchange of information about other governments, not about individual taxpayers) and might actually improve the accuracy, efficiency, and effectiveness of all parties by doing so.

[6] The individual state and Social Security Administration (or its predecessor named in those agreements, the Department of Health, Education, and Welfare) are parties to each agreement and modification entered into on behalf of any portion of the state or its political subdivisions. The IRS (FSLG) has assumed the responsibility of enforcing these agreements, but is restricted in communicating with the other party to the agreement.

[7] Examples of information maintained by State Administrators that would be beneficial to the IRS's education and compliance efforts with public employers are: all Modifications associated with the public employer and its employees, audits and compliance reviews conducted by the state of the public employer, the ordinance or other official document authorizing Social Security or Medicare-only coverage for particular employees of the public employer, any issue-related correspondence and SSA or State Attorney General's (AG) opinions, such as whether or not marshal positions are police officers for Social Security purposes, "Plan and Agreement" entered into between the State and the public employer which states the employer's responsibilities.

2. **The IRS/FSLG should implement, as soon as possible, the 2006 recommendations of the Treasury Inspector General for Tax Administration (TIGTA), which were mentioned in the 2010 GAO report.**

   Implementation of those recommendations will enable the IRS/FSLG to improve and expand analysis and timely use of data obtained from education and compliance efforts. Implementation will also facilitate the ability to share that information with partners who help ensure proper assessment of FICA taxes, i.e., with other federal (SSA) and state (State Administrators) officials.

   The GAO report found that recommendations made by the Treasury Inspector General for Tax Administration (TIGTA) in 2006 still were not met as of the date the GAO issued its report in September 2010.[8] Among the problems TIGTA identified that GAO also found four years later were the IRS still does not know what percent of the employers involved in compliance checks did not comply with the state's Social Security coverage agreement.[9] The GAO also noted that, for examinations, FSLG does not know if cases that resulted in an adjustment to the employers' taxes are due to errors with Social Security coverage agreements. According to the GAO "FSLG officials told us they do not yet know the prevalence of coverage problems and have not done enough audits to fully understand the extent of the problems."[10]

3. **Agreements entered into, associated with sharing information, need to be consistently applied and adhered to throughout FSLG.**

   For example, the GAO report found that although a Memorandum of Understanding (MOU) between the IRS/FSLG and SSA has existed since 2002: "SSA does not validate IRS's database of public employers – including covered employers – which may not always contain correct data. Moreover, the lack of current or consistently tracked data can limit the efficiency with which [SSA] regions research or answer questions about a particular employer."[11] **The GAO report further documented that 8 of 10 SSA regions told the GAO that the IRS does not typically share the results of its enforcement activities, and the IRS agreed** (emphasis added).[12] According to the GAO report, only minimal information sharing with State Administrators has occurred since the MOU was adopted, with FSLG citing restrictions imposed by IRC Section 6103 as the reasons for not doing so.[13]

   The ACT recommends that the IRS establish a consistent, nationwide policy that ensures it shares the results of its enforcement activities with all SSA regions and

[8] GAO Report (GAO-10-938), pp. 29-30.

[9] GAO Report (GAO-10-938), p. 29.

[10] GAO Report (GAO-10-938), p. 30.

[11] GAO Report (GAO-10-938), p. 21.

[12] GAO Report (GAO-10-938), p. 23.

[13] GAO Report (GAO-10-938), p. 26.

headquarters. The ACT further recommends that summary information (i.e., non-taxpayer specific information) on its enforcement activities be shared with NCSSSA and State Administrators nationwide. If IRC Section 6103 is amended to permit the IRS to share taxpayer information with State Administrators then more detailed information can, and should, be furnished to the appropriate State Administrators, as permitted by law.

4. **The ACT further recommends that the IRS/FSLG continues to partner with, and expand the use of NCSSSA and SSA in its education and outreach efforts to public employers. FSLG should also ensure involvement with both NCSSSA and the SSA in all updates made to IRS Publication 963 (*Federal-State Reference Guide*).**

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II. Introduction

In 2009, the U.S. House Ways and Means Committee asked the Government Accountability Office (GAO) to examine how Social Security coverage for state and local government ("public") employees is being administered by the federal government (i.e., the Social Security Administration which is responsible for ensuring accurate reporting of Social Security earnings, and the IRS which is responsible for collecting employment taxes from public employers). In September 2010, the Government Accountability Office (GAO) issued its Report to Congressional Requesters entitled, "Social Security Administration: Management Oversight Needed to Ensure Accurate Treatment of State and Local Government Employees" (GAO-10-938). The GAO report arose from concerns about how the voluntary Social Security and Medicare coverage agreements (commonly referred to as Section 218 Agreements because they are authorized by Section 218 of the U.S. Social Security Act) were being administered throughout the country.[14]

Due to the extent of the problems that were identified in Missouri from the 2009 Task Force report, Congress became concerned that other states might have similar issues. Thus, Congress requested the study by the GAO, which resulted in its 2010 report.

The Federal Section 218 Task Force for Missouri School Districts report identified the following major Social Security coverage and taxation issues that had developed in the Missouri schools:

A. Some employees covered by the Missouri Public School Retirement System were also covered by Social Security, but were not paying Social Security taxes.

B. Some employees in some school districts were erroneously paying Social Security taxes because the school districts did not follow the required statutory process to request Social Security coverage for these employees.

C. Since the original Section 218 Agreement for the State of Missouri had been entered into with the federal government[15] in 1951, Missouri had adopted a number of statutory changes to either expand coverage of a retirement system or provide an employee the option to choose between two retirement systems. Those changes, in some cases, resulted in some public employers in Missouri erroneously thinking they could choose between Social Security and a retirement system.[16]

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[14] This fact was documented by an issue that arose in the State of Missouri. See the final Task Force Report for a description of the problem and how it had to be addressed by multiple individuals and agencies: M. Grochowski, et al., *REPORT: Federal Section 218 Task Force For Missouri School Districts*, March 31, 2009, http://oa.mo.gov/acct/033109FederalTaskForceReport.pdf.

[15] The U.S. Department of Health, Education and Welfare was the responsible federal agency that entered into Section 218 Agreements with the states in 1951. The Social Security Administration was given the operational responsibility for administering the Section 218 Agreements on behalf of the federal government and, since 1994, is a separate federal agency.

[16] Originally Section 218 of the Social Security Act permitted public employers to withdraw from the voluntary coverage agreements. Federal law was amended, effective April 20, 1983, to require continuation of Social Security (or, later,

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Medicare-only) coverage once a Section 218 Agreement or modification to the agreement was entered into extending coverage to public employees. Public Law 98-21 (April 20, 1983); see also *Bowen v. Agencies Opposed to Soc. Sec. Entrap*, 47 U.S. 41 (1986).

III. Justification for the Project

The GAO report identified a number of concerns and areas for improvement to facilitate tax compliance by state and local governments. Proper Social Security and Medicare or public pension system coverage of public employees is vital to providing for their retirement (and disability or survivors') security. Accurate assessment of FICA taxes by the IRS is critical to that process.

State and local governments are a significant labor force in the nation. Both levels of government have numerous employees, with significant payrolls. Many also fund public employee retirement systems that account for a large subset of the economy of the country. For example, the latest U.S. Bureau of the Census data[17] indicates that there are 89,526 state and local governments throughout the country. Census data show that, as of 2008, state and local governments had more than 19.7 million employees (88 percent of all civilian government employment in the country), with a payroll of more than 67.8 billion dollars (81 percent of the total government payroll nationwide). The Census Bureau projected the 2008 estimate of participants in state and local public employee retirement systems was nearly 19.1 million, and nearly 3.2 trillion dollars in assets.[18]

The GAO report documented the Social Security-covered and estimated noncovered earnings from state and local government employment (as of 2007).[19] The GAO report notes that nationwide 71 percent of state and local government earnings were covered for Social Security, with total Social Security covered earnings totaling 527.5 billion dollars. The percent of state and local government earnings covered for Social Security ranges from a low of one (1) percent in Ohio to 99 percent (in both New York and Vermont).

This ACT project is justified, therefore, because it provides insights into the GAO report from both the state/local government (employer) and State Administrator perspectives. It also identifies resources, such as State Social Security Administrators, who can assist the IRS in accomplishing its responsibilities to ensure taxpayers pay the appropriate taxes and have the proper pension and Social Security/Medicare coverage and benefits. By fully using the State Administrators as a true bridge between state and local governments and the IRS, voluntary compliance can be improved and the cost to administer FSLG (and the public retirement system portion of Employee Plans) can be reduced. This approach is consistent with the Department of the Treasury and the IRS's goal of improving compliance with the U.S. tax code, including focusing on increasing voluntary compliance as a means to reduce the tax gap.[20]

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[17] *The 2011 Statistical Abstract*, U.S. Bureau of the Census, Table 426 (Number of Governmental Units by Type: 1962 to 2007): http://www.census.gov/compendia/statab/2011/tables/11s0427.pdf, Table 459 (Governmental Employment and Payrolls: 1982 to 2008): http://www.census.gov/compendia/statab/2011/tables/11s0546.pdf , and Table 546 (Public Employee Retirement Systems – Participants and Finances: 1980 to 2008): http://www.census.gov/compendia/statab/2011/tables/11s0546.pdf .

[18] Excludes Social Security and state and local plans that are fully supported by employee contributions.

[19] GAO Report (GAO-10-938), pp. 40-42.

[20] For a detailed discussion of the tax gap and plans the Department of the Treasury and IRS has to address it, go to: *Reducing the Federal Tax Gap - A Report on Improving Voluntary Compliance*, Internal Revenue Service and U.S.

Identifying barriers to the collaboration and cooperation among the IRS, SSA, and State Administrators and determining how to eliminate those barriers to voluntary compliance by public employers with federal (and state) laws is advantageous to the federal government (particularly the IRS and SSA in their roles in implementing the laws passed by the U.S. Congress), to public employers and employees, but, most importantly, to the taxpayers and citizens of the U.S. for whom **all** public employers and employees work, under our federal system of government. The GAO report outlined a number of such barriers and this report of the ACT makes specific recommendations to the IRS on how those barriers can be reduced or eliminated.

Department of the Treasury, August 2, 2007, http://www.irs.gov/pub/irs-news/tax_gap_report_final_080207_linked.pdf.

IV. Project Process

The ACT FSLG Subcommittee members reviewed the GAO report and analyzed its implications for the IRS vis-à-vis how the FSLG office within the Tax Exempt and Government Entities (TE/GE) division of the IRS can improve its organizational focus and service level to state and local government employers and employees.

To further facilitate the recommendations provided by the ACT to the IRS in this regard, the ACT obtained feedback from the National Conference of State Social Security Administrators (NCSSSA). NCSSSA is the only professional organization for State Social Security Administrators (State Administrators) in the country. The NCSSSA provided valuable additional stakeholder perspectives on the GAO report and applicable feedback and recommendations to assist FSLG (and Employee Plans) in improving their services to the state and local government community.

The NCSSSA was established in 1952 to provide a unified state administrator's perspective at the federal level to ensure ongoing problem solving and to maintain an open forum for the development of new policy. The NCSSSA works with federal officials to ensure legislative and regulatory changes address state and local concerns. The NCSSSA provides leadership to state and local governments through accurate interpretation of state and federal laws and regulations, communication of federal tax policy, and resolution of problems arising at the state and local levels. The NCSSSA continues to serve its constituents with a presence before Congressional staff, U.S. Treasury officials, the Internal Revenue Service, and the Social Security Administration. The NCSSSA hosts an annual conference where current issues and concerns are addressed. (See http://www.ncsssa.org/presentconferencesite.html for further information). Thus, in analyzing and interpreting the GAO report, NCSSSA was a logical stakeholder organization from whom the ACT obtained input for this report.

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V. History of State and Local Government Social Security and Medicare Coverage

When initially adopted in 1935, the Social Security Act did not include public employees as eligible for Social Security because of the Constitutional question regarding the power of the federal government to tax sovereign entities, i.e., the states. Many government employers did not have their own retirement systems so in 1950 the United States Congress amended the Social Security Act to allow states to ***voluntarily*** enter into agreements with the Social Security Administration, on behalf of the Department of Health and Human Services. This permitted state and local government employers to offer Social Security coverage to their employees, if the employers so desired. These agreements are often referred to as "Section 218 Agreements" because they are authorized by Section 218 of the Social Security Act. Social Security coverage was not mandated for state and local government employees at that time.

Subsequently, significant legal and political changes occurred that eventually resulted in "mandatory" Medicare coverage for some public employees (all newly hired state and local public employees, effective April 1, 1986); and resulted in "mandatory" Social Security and Medicare coverage for virtually all state and local public employees since July 2, 1991, who are not covered by a qualifying Federal Insurance Contribution Act (FICA)-replacement public retirement system, or are not already covered under a Section 218 Agreement.

See the *Federal-State Reference Guide*, IRS Publication 963, at http://www.irs.gov/pub/irs-pdf/p963.pdf for further details on the history of state and local governments' Social Security and Medicare coverage and benefits, FICA tax obligations, and public pension system requirements.

Because of the many unique federal laws that apply to state and local governments' employment tax obligations as well as the varied ways that each of the states in the nation enacted Section 218 of the Social Security Act, compliance by public employers with those laws can be challenging. See **Appendix A** for an article that was published in 2009 by the Government Finance Officers Association in its *Government Finance Review* that explains the common mistakes that occur related to state and local governments' FICA and public retirement system compliance.

Federal regulations[21] require every state to appoint an official to serve as the State Social Security Administrator. The State Administrator is the person responsible for administering the Section 218 Agreements for each state. Until 1987, the State Administrator was also responsible for collecting the Social Security and Medicare contributions (now referred to as the FICA taxes) from the state and local employers and depositing the funds with the United States Treasury. When the IRS assumed this function in 1987, many states interpreted this change in the law as eliminating any further responsibilities, but the majority of functions and responsibilities of the State Administrator continue. Further, since that time, the responsibilities have become even more complicated, because of the advent of the mandatory Social Security and Medicare provisions.

[21] 20 C.F.R. 404.1204.

Due to the complexity of the laws that apply to state and local governments' employment tax obligations,[22] the State Social Security Administrator in each state serves as an important liaison – or "bridge" – between the federal government (both the IRS and Social Security Administration) and the state and local government employers in the state. The State Administrator is charged by his/her state with administering the Section 218 Agreement entered into between the state and Social Security Administration (or its predecessor federal agency). Individual public employers in each state are added to the state's master 218 Agreement through "modifications," each of which must be initiated by the public employer and processed by the State Administrator (according to federal and state laws), and approved by the Social Security Administration before they become official.

[22] See the Advisory Committee on Tax Exempt and Government Entities Report of Recommendations (June 2009), Federal, State and Local Governments Subcommittee report for details: http://www.irs.gov/pub/irs-tege/tege_act_rpt8.pdf.

VI. Analysis of Government Accountability Office Report

The GAO report focused on two major questions:

- How SSA works with states to approve Social Security coverage and ensure accurate coverage of public employees, and
- How IRS identifies incorrect Social Security taxes for public employees.

The GAO report documented the shared responsibilities for administering Section 218 Agreements[23] as follows:

Public Employer (e.g., local government)
- Request coverage for employees.
- Comply with coverage provisions in any changes to the coverage agreement.
- Withhold Social Security and Medicare taxes.

State Administrator
- Act as bridge between state, local, and federal agencies.
- Prepare changes to coverage agreement.
- Maintain files of changes to coverage agreement and all relevant documents.

Social Security Administration (SSA)
- Maintain and interpret coverage agreements.
- Maintain employees' record of earnings.
- Approve changes to coverage agreements.

Internal Revenue Service (IRS)
- Assure proper reporting and collection of Social Security and Medicare taxes.
- Public tax guidance.

The GAO reported at length about problems associated with state and local coverage and FICA tax compliance, including major areas of concern as they relate to the accuracy and efficiency of tax collection by the IRS:[24]

A. GAO Comments or Recommendations: In 2002, SSA and IRS signed a Memorandum of Understanding (MOU), included in **Appendix B**, which created a joint SSA and IRS committee to share information on policies, procedures, and compliance issues. The MOU delineates the responsibilities of the IRS and SSA for performing compliance reviews, educating public employers, and improving the reporting process between SSA and IRS to detect compliance problems. The MOU further states, in pertinent part:

[23] GAO Report (GAO-10-938), p. 8.

[24] The GAO report documented other problems that are outside the scope of the ACT's authority to comment on, including the Social Security Administration Structure and Program Implementation. Further information on issues specific to SSA (and State Administrators) can be found in the GAO report.

"Additionally, this MOU addresses activities intended to improve the wage reporting of state and local government entities. These specifically include the responsibilities of the IRS and SSA regarding meeting the educational needs of public employers and improving the operational and informational exchanges between the agencies.

. . .

"SSA and IRS will review IRS Publication 963, Federal-State Reference Guide, for State and Local Government Employers, a multiagency document published by the IRS, to determine whether a revision of the publication is necessary. New editions of Publication 963, or supplementary publications (additions/deletions), will be created jointly by the IRS and SSA.

"The Section 218 Committee will evaluate information exchange methods for data concerning state and local government employers and will periodically provide recommendations for improving the coordination process. As an essential part of this process, the Committee will study the feasibility of perfecting the Section 218 Agreement/Modification information retained in IRS and SSA databases. The Section 218 Committee will consider sharing perfected Section 218 Agreement/ Modification data with State Social Security Administrators."[25]

ACT Comments: Despite the existence of the MOU since 2002, the GAO's 2010 report noted that "SSA does not validate ***IRS's database of public employers – including covered employers – which may not always contain correct data. Moreover, the lack of current or consistently tracked data can limit the efficiency with which [SSA] regions research or answer questions about a particular employer***"[26] (emphasis added). The GAO report further documented that 8 of 10 SSA regions told the GAO that the IRS does not typically share the results of its enforcement activities and the IRS agreed.[27] According to the NCSSSA, only minimal information sharing with State Administrators has occurred since the MOU was adopted. Restrictions imposed by IRC Section 6103 are cited as the reasons for not sharing information.

The ACT recommends that the IRS establish a consistent, nationwide policy that ensures sharing results of enforcement activities with all SSA regions and headquarters. The ACT further recommends that summary information (i.e., non-taxpayer specific information) on enforcement activities be shared with NCSSSA and State Administrators nationwide. If IRC Section 6103 is amended to permit the IRS to share taxpayer information with State Administrators then more detailed information can, and should, be furnished to the appropriate State Administrators, as permitted by law.

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[25] Memorandum of Understanding Between the Social Security Administration and the Internal Revenue Service for State and Local Government Compliance Issues, 2002.

[26] GAO Report (GAO-10-938), p. 21.

[27] GAO Report (GAO-10-938), p. 23.

Also, despite Publication 963 having been originally created jointly in 1995 by the State of Colorado, IRS, and SSA, and having those creators agree to continue that partnership with NCSSSA (replacing Colorado as the states' representative), the MOU does not mention NCSSSA's involvement in updates of the publication. The preface to subsequent editions of the publication, however, continues to acknowledge its joint sponsorship and that NCSSSA is an equal partner in maintaining the quality and value of the publication, stating, in pertinent part:

"The *Guide* was first published by the Internal Revenue Service (IRS) in July 1995 with special assistance from the State of Colorado, and is a cooperative effort of the Social Security Administration (SSA), the IRS, and the National Conference of State Social Security Administrators (NCSSSA)."[28]

The ACT recommends that the IRS continue to include and expand the use of NCSSSA and SSA in its education and outreach efforts to public employers, including actively involving both in all updates to IRS Publication 963 (*Federal-State Reference Guide*).

B. GAO Comments or Recommendations: SSA does not have a process to ensure that public employers only report wages for covered employees and that such wages are associated with valid coverage under the state's coverage agreement. If the wage amounts on the Forms W-2 and 941 match, SSA does not follow-up to ensure that reported wages actually reflect public employees who are covered by the state's agreements. SSA does not compare the reported wages with coverage modifications applicable to the employer. Data are not collected to verify that employees are in positions that are covered by their state's agreement. Prior to 1987 (when the IRS became responsible for collecting the FICA taxes from state and local government employers), the SSA conducted regular oversight activities to ensure more accurate reporting. Prior to 1987, State Administrators were responsible for collecting the contributions and transmitting them to the U.S. Treasury; and states were, therefore, accountable for payments from public employers and employees in their states.

ACT Comments: This issue, while addressed to the SSA by GAO, is included in this ACT report because the IRS receives the 941's and is responsible for working with the SSA on matching information reports on Forms W-2 and 941. Further, the IRS makes similar mistakes when conducting compliance checks and examinations of public employers, by not comparing the reported wages with coverage modifications that apply to particular employers. The GAO report documented[29] that all of the IRS field offices do not have all modifications to the Section 218 Agreements, thereby making it problematic that the FSLG officials are accurately assessing the proper FICA taxes on public employers.

[28] *Federal-State Reference Guide* (IRS Publication 963), p. ii, available at http://www.irs.gov/pub/irs-pdf/p963.pdf.

[29] GAO Report (GAO-10-938), p. 28.

Ironically, most of the information the GAO report mentions as impairing the IRS's (and SSA's) ability to properly administer the Social Security Act and Internal Revenue Code, as they apply to state and local governments, actually is available from State Administrators. Due to the interpretation of IRC §6103, however, except in extremely rare circumstances, the IRS will not contact State Administrators when they are conducting compliance checks and examinations of public employers. Examples of information maintained by State Administrators that would be beneficial to the IRS during both it's education and compliance efforts with public employers are:

1. All Modifications associated with the public employer and its employees;
2. Any audits and compliance reviews conducted by the state of the public employer;
3. The ordinance or other official document authorizing Social Security or Medicare-only coverage for particular employees of the public employer;
4. Any issue-related correspondence, including official rulings by the U.S. Social Security Administration or State Attorney General's Office, such as whether or not marshal positions are police officers for Social Security purposes;
5. The "Plan and Agreement" entered into between the State and the public employer which states the employer's responsibilities;
6. Accounting records for all Social Security and Medicare contributions paid to the U.S. Treasury by a state and its political subdivisions for pre-January 1, 1987, employees;
7. Miscellaneous forms of correspondence and information related to Social Security and/or Medicare coverage and benefits and tax obligations for public employers covered by Section 218 Agreements;
8. Information on non-Section 218 public employers who are subject to the mandatory Medicare and mandatory Social Security provisions.

See **Appendix C** for a copy of the Onsite Review that was conducted by the U.S. Social Security Administration of Colorado's State Administrator records, documenting what information must be retained and what can be destroyed (such as the pre-1987 accounting records if all payments were reconciled with the Social Security Administration and the state). The requirements listed in that document apply to all State Administrators' offices throughout the country. Thus, that list of information can be relied upon by the IRS as SSA's standards for what information can, and should, be available from State Administrators' records.

Are some states' records not as complete as others -- thereby their information would not be as useful to the IRS? Of course, that is true; but that should not be the basis for the IRS not accessing whatever information IS available. FSLG staff should also be requested to compare reported wages to Section 218 Agreement coverage modifications and interpretive information on coverage applicable to each public employer and appropriate groups of their employees.

C. GAO Comments or Recommendations: The GAO mentioned the conference that SSA hosted in April 2010 that included the IRS and state administrators to explore options for improving how coverage agreements are administered.[30] Participants in the conference identified a number of proposals to reduce the complexity of public employees' coverage and formed a number of committees consisting of representatives from the IRS, SSA, and the states to, among other things, improve training of all parties as well as improve policies and procedures.

ACT Comments: The ACT was advised by NCSSSA representatives, who have been participating in the committee activities noted above, that during the January 2011 meeting SSA officials announced plans to complete all committee activities by the end of the current federal fiscal year (i.e., September 30, 2011). According to NCSSSA, efforts to form a joint (IRS, SSA, and state/NCSSSA) "Section 218 Council," which was originated by the IRS/FSLG participants during the April 2010 conference in Baltimore, were stalled due to concerns the IRS and SSA have about sharing information with State Administrators related to IRC disclosure restrictions. Efforts to form the Section 218 Council are now progressing in a positive manner that should result in a collaborative mechanism for the IRS, SSA, and NCSSSA (on behalf of all State Administrators) that will be proactive, thereby helping to prevent future problems such as were identified in the State of Missouri. (See footnote number [14] in this report.)

The ACT recommends that the IRS work with SSA and NCSSSA to formalize an ongoing working relationship among the three parties that will continue after the current 218 conference follow-up committee activities conclude at the end of the current federal fiscal year. This is critical to ensuring accurate FICA tax collection and proper Social Security/Medicare coverage for all public employees nationwide.

The ACT recommends that FSLG ensure uniform training and information dissemination on Section 218 coverage for public employers is provided to all of the FSLG staff.

D. GAO Comments or Recommendations: As part of its study, the GAO reviewed a nongeneralizable sample of 20 compliance checks[31] completed by the IRS during fiscal year 2009 that the IRS identified as having issues related to Social Security coverage agreements. The GAO noted that:

"In 11 of these cases, the public employer was not covered under the state's Social Security coverage agreement. In 6 of the other cases in which the state or local government employer was actually covered under the state's coverage agreement, IRS found that the employer did not have a copy of its modification

[30] GAO Report (GAO-10-938), pp. 23-24.

[31] Compliance checks review public employer tax returns and are typically less detailed than an examination. Usually, compliance checks are performed on smaller public employers and are used as a method of reaching out to employers to educate them on their tax obligations.

and in one of these cases, the employer did not know one was in effect. In another case, a school district that was covered under its state agreement dissolved, and then combined with another school district that also was subject to a modification. The school district being reviewed was not certain if the coverage agreement was still in effect and planned to contact the state Social Security administrator to determine if a new modification was necessary."[32]

ACT Comments: The ACT recommends that the IRS contact State Administrators in each state prior to conducting compliance checks and examinations to verify the coverage applicable to each public employer/ employee. The IRS should use any and all powers or authorities to secure Section 218 Agreements and modifications and related entity information from the State Administrator as a normal course of business. According to information provided to the ACT by NCSSSA, however, Treasury Counsel and the IRS have stated that Congressional action is necessary to change 26 IRC §6103, before the IRS can formally involve State Administrators in such discussions.

Until IRC §6103 is amended, when conducting compliance checks and examinations, the IRS/FSLG specialists should advise the public employers about Form 8821 (Tax Information Authorization). Form 8821 permits the IRS to share information with the State Administrator, if the public employer so states. According to NCSSSA, however, the use of that form has been minimal and ineffective. Data on its use has not been made available by the IRS. Public employers are frequently concerned about bringing in another government official (i.e., from the state) when they are being audited by the IRS. For example, one of the most experienced State Administrators, Ms. Linda Yelverton, who has been serving Louisiana since 1971, has never received such an authorization even though she is one of the most active and proficient State Administrators in the nation and well-respected by the public employers she serves in her state. Thus, Form 8821 is an insufficient substitute for having the disclosure laws changed to ensure adequate and complete information sharing between the IRS and State Administrators when the IRS is determining the proper FICA taxes to assess a particular public employer.

The ACT recommends that the IRS, in consultation with the Treasury Secretary, SSA, and NCSSSA, work with Congress to amend IRC §6103(i) to include authorization for the Secretary of the U.S. Treasury to disclose tax information obtained from state or local governments with the officials designated to administer the Section 218 Agreements entered into between the Social Security Administration and the states, i.e., the official designated pursuant to 20 C.F.R. §404.1204 (the State Administrator). The change should also codify the information-sharing between SSA and the IRS that is currently only based on a Memorandum of Understanding, which the GAO report noted is not uniformly followed by the IRS. In fact, the GAO reports states:

[32] GAO Report (GAO-10-938), p. 25.

"The MOU between IRS and SSA states that it serves as such a request [required by 26 U.S.C. §6103(l)(1)(A)], but IRS still does not generally tell SSA about its examinations and compliance checks because, according to IRS officials, many of its examiners are not aware of the MOU. According to IRS officials, state administrators do not have an exception to the disclosure requirements so the agency is prevented from providing information to them."[33]

This change will ensure accurate FICA tax collection and proper coverage for public employees, thereby freeing up the IRS to use its limited resources on pursuing tax fraud and other intentional violations of the tax code. In February 2011, NCSSSA sent a letter to U.S. House Ways and Means Committee Chairman Camp formally requesting amendment of that section of the Internal Revenue Code to include the State Administrator as a named official with whom the Treasury Secretary and the IRS can share taxpayer information.

E. GAO Comments or Recommendations: The GAO report commented on the IRS's examination activities. It noted that, unlike compliance checks, examinations are in-depth, formal audits that may result in a tax assessment. The examinations review numerous areas, including proper Social Security withholding, fringe benefits, and public retirement systems. The IRS examiner is supposed to obtain information about the applicable Social Security coverage agreement and determine the employees who are covered. GAO noted that to make its coverage determination, the IRS examiners must review employer records and may informally contact the state administrators and SSA. Usually examinations are performed on larger public employers and take an average of nearly nine months to complete (in fiscal year 2009). If errors are found, the IRS can either make a tax assessment for the amount owed by the employer, or, among other things, refund an overpayment. The GAO went on to note:

"Generally, IRS does not provide information about its enforcement activities to SSA or state administrators. IRS is subject to statutory provisions that generally prevent it from disclosing taxpayer information unless there is an exception authorizing disclosure in the law.[34] One such exception is for purposes of administering certain portions of the Social Security Act, in which case the information can be disclosed to SSA upon a written request.[35] The MOU between IRS and SSA states that it serves as such a request, but IRS still does not generally tell SSA about its examinations and compliance checks because, according to IRS officials, many of its examiners are not aware of the MOU. According to IRS officials, state administrators do not have an exception to the

[33] GAO Report (GAO-10-938), p. 26.

[34] 26 U.S.C. § 6103.

[35] 26 U.S.C. § 6103(l)(1)(A).

disclosure requirements so the agency is prevented from providing information to them."[36]

ACT Comments: The ACT recommends that the IRS, in consultation with the Treasury Secretary and NCSSSA, work with Congress to amend IRC §6103(i) to include authorization for the Secretary of the U.S. Treasury to disclose tax information obtained from state or local governments with the officials designated to administer the Section 218 Agreements entered into between the states and the Social Security Administration, i.e., the official designated pursuant to 20 C.F.R. §404.1204 (the State Administrator). See additional comments for D, above, for details.

The ACT also recommends that FSLG share the MOU with its staff and mandate that all of its examiners adhere to the MOU's requirement by informing SSA of its examination and compliance check activities. Further, the ACT recommends that FSLG train all staff on the MOU's terms and conditions including how it affects the sharing of information.

F. GAO Comments or Recommendations: The GAO report found that the IRS's compliance efforts are limited by a lack of Social Security coverage information. The GAO noted that the IRS receives limited information about public employers' Social Security coverage. The IRS told the GAO they started to receive copies of coverage modifications from SSA around fiscal year 2000, but "IRS generally does not distribute copies of the modifications to all field offices. To obtain a completed set of modifications, IRS officials in one field office told us they went to the SSA regional offices and duplicated them."[37]

ACT Comments: See comments listed above for E.

G. GAO Comments or Recommendations: The IRS developed an assessment document in 2009 that was designed to identify states with potential coverage problems. At the time the GAO report was issued, the IRS had not completed its collection of information from all states, nor had it compiled an analysis of its findings and conclusions regarding possible compliance issues.

ACT Comments: The ACT recommends that the IRS work with both the SSA and NCSSSA to interpret the information it has collected as part of this initiative. Accurate application of the information obtained by the assessment document is contingent upon a thorough understanding of the nuances applicable to each state's laws, modifications, and interpretive documents contained in State Administrators' records.

[36] GAO Report (GAO-10-938), pp. 25-26.

[37] GAO Report (GAO-10-938), p. 28.

H. GAO Comments or Recommendations: The GAO report noted that the ACT Committee had developed a detailed self-evaluation document for public employers to use to assess their own compliance levels. The self-evaluation document expanded upon the IRS's internal checklist that it used for compliance checks to included understandable information on employment tax requirements, such as Social Security and Medicare coverage and taxes. The GAO noted that the IRS planned to refine and post the document on its website. That was actually done in January 2011 and is on the IRS's website at: http://www.irs.gov/govt/fslg/article/0,,id=232452,00.html .

ACT Comments: The ACT is extremely pleased by the rapidity with which the IRS implemented the self-evaluation tool the ACT created and recommended be implemented during its 2010 report.[38]

I. GAO Comments or Recommendations: The GAO report reviewed a 2006 Treasury Inspector General for Tax Administration (TIGTA) report[39] that had examined the IRS's FSLG workload selection process and found issues related to tracking the effectiveness of the indicators used to select cases for review and to analyze the results of compliance checks. TIGTA found the IRS was not systematically analyzing the effectiveness of its selection process and stated that, with that information, the IRS could identify more productive indicators and provide baseline measures of the levels of noncompliance identified. IRS officials told the GAO that they were conducting a special analysis of the indicators used for its examinations and compliance checks conducted in 2006, 2007, and 2008, and hoped to have the analysis completed by 2011.[40] As of the date of this ACT report, the ACT/FSLG Subcommittee members were advised that the analysis is in draft form, but must be reviewed and given clearance before it is issued.

ACT Comments: The ACT recommends that the IRS work with SSA and NCSSSA to identify more productive indicators and baseline measures applicable to each state's unique Social Security/Medicare and public pension coverage situation.

J. GAO Comments or Recommendations: The 2006 TIGTA report had also found that the IRS was not analyzing the results of completed compliance checks to identify common issues found during reviews. The GAO found that during its work in 2009-2010 the IRS still was not routinely conducting such an analysis.

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[38] Advisory Committee on Tax Exempt and Government Entities (ACT) Report of Recommendations, June 2010: http://www.irs.gov/pub/irs-tege/tege_act_rpt9.pdf .

[39] Treasury Inspector General for Tax Administration, *The Federal, State and Local Governments Office Can Improve the Workload Selection Process to Increase Effectiveness*, 2006-10-073 (Apr. 28, 2006).

[40] GAO Report (GAO-10-938), pp. 29-30.

"For compliance checks, the IRS tracks the number of employers who were issued a discrepancy letter, but not the number that had issues related to Social Security coverage. In fiscal years 2007 to 2009, IRS issued discrepancy letters to over 79 percent of the public employers that had a compliance check. However, IRS does not know what percent of the employers did not comply with the state's Social Security coverage agreement. In 2009, IRS performed a special analysis of its 2008 compliance checks to determine the issues found during the year. IRS found that 4.1 percent of all of its closed compliance checks had Social Security coverage issues. In 2006, TIGTA concluded that by analyzing the results of its compliance checks, IRS could identify common issues and focus its work for future compliance checks."[41]

The IRS told GAO it was conducting additional special analysis of the results of its compliance checks and examinations to identify the most common areas of noncompliance. The IRS stated they intended to conduct focused outreach to state and local government employers to address those concerns.[42]

ACT Comments: The ACT recommends that the IRS work with SSA and State Administrators when conducting all education and outreach to public employers. NCSSSA should be involved in assisting with designing and developing the materials used during those education and outreach sessions.

K. GAO Comments or Recommendations: FSLG tracks the number of examination cases that resulted in an adjustment to the employers' taxes, but does not know if such tax adjustments are due to errors with Social Security coverage agreements.

"FSLG officials told us they do not yet know the prevalence of coverage problems and have not done enough audits to fully understand the extent of the problems. We requested the closed examinations for fiscal year 2009 that had issues related to Social Security coverage agreements. FSLG officials stated that due to constraints in their information system, they could not identify all of these cases and, at best, could provide a list of examinations that might indicate Social Security coverage agreement issues using the amount of wage adjustments. We selected and reviewed a sample of 10 closed examinations provided by IRS that had large wage changes. In 5 of these examinations, the public employer did not have an error related to its coverage agreement. In 3 of the 5 cases in which errors were found with coverage agreements, the public employer misclassified the employees for whom it was not paying Social Security taxes. For example, some Social Security coverage agreements exclude certain categories of employees, such as student workers. In one of these cases, IRS conducted an examination of a public employer with student workers and determined that some of the employees classified as students were not actually taking classes at the

[41] GAO Report (GAO-10-938), p. 29.

[42] GAO Report (GAO-10-938), p. 30.

time. As a result, IRS found that the employer was responsible for paying Social Security and Medicare taxes for these employees.

. . .

"In fiscal years 2007 to 2009, over 89 percent of employers examined had tax adjustments, but the reasons for those tax adjustments are not tracked."[43]

ACT Comments: The ACT recommends that the IRS track Social Security (and Medicare-only)-related adjustments and share that information with SSA and NCSSSA so proactive intervention with public employers in each state can occur.

L. GAO Comments or Recommendations: The GAO cited a study that involved examinations that were conducted by the IRS and summarized in a 2009 report of 88 community colleges that were chosen by random sample. The study by the IRS showed that 10 percent of the 88 employers incorrectly excluded workers who should have been covered by their state's Social Security coverage agreements.[44]

ACT Comments: The ACT recommends that the IRS work with SSA and State Administrators when interpreting findings from studies it conducts of public employers to ensure the information is accurate and complete. The results of such studies and other data analysis can then, in turn, be used by all parties to provide the most effective education and outreach to public employers that is possible. NCSSSA should be involved in assisting with designing and developing the materials used during those education and outreach sessions and in helping to interpret studies and data obtained by the IRS from public employers.

[43] GAO Report (GAO-10-938), pp. 30-31.

[44] GAO Report (GAO-10-938), pp. 31-32.

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VII. Conclusions

Efficient and effective state and local governments' FICA tax compliance involves four key parties:

1. **U.S. Social Security Administration** – responsible for maintaining accurate and complete benefit records and ensuring coverage of public employees is proper, based on applicable Section 218 Agreements and modifications.
2. **U.S. Internal Revenue Service** – responsible for tax administration and ensuring public pension plans are sufficient FICA-replacement plans (for mandatory Social Security provision purposes).
3. **State Social Security Administrators** (in 52 states)[45] – responsible for administering and managing their state's voluntary coverage (Section 218) Agreements and serve as the "bridge" or liaison between the federal government (SSA and IRS) and state and local government employers in their states.
4. **Public employers** – responsible for collecting and transmitting the proper FICA taxes to the U.S. Treasury and ensure compliance with public retirement system requirements.

To illustrate the importance of all four parties working collaboratively, it helps to visualize a four-legged stool, with each of the four parties representing one of the legs of the stool. If any one of the legs fails to "hold up" its portion of the burden or weight of the stool or does not work cooperatively with the other three, then the stool gets wobbly and eventually collapses entirely. To maintain the integrity of tax administration in this area, therefore, it is critical that all four parties work together.

As one of the "legs of the stool," the State Administrators are vital because they are charged with maintaining all records associated with the state's Section 218 Agreement and all subsequent modifications to that agreement, making decisions as to which state and local employees need to be covered under Social Security or Medicare, based on those Agreements/Modifications. They also need to know all of the statutes, laws and regulations related to such agreements and to all public pension plans and must provide timely and accurately advise all state and local governments. They must also monitor proposed legislative actions in their states, which may conflict with the federal laws, to ensure public employers are not given "options" to change their Social Security/Medicare coverage that are illegal.[46] Since 1987, when the responsibility for collecting the FICA taxes from public employers was transferred from the State Administrators to the IRS, many state governments no longer take this responsibility seriously. Many State Administrators are ill-equipped, understaffed, and lack the time and training to provide

[45] Section 218 of the U.S. Social Security Act, codified at 42 U.S.C. §418, authorized all states, plus Puerto Rico and the Virgin Islands (both of which are considered states for the purposes of that section of the law), to enter into voluntary Social Security (Section 218) coverage agreements on behalf of their state and local governmental employers/employees. State Administrators are the officials in each state that administer those Section 218 Agreement on behalf of their states.

[46] See the discussion in the Introduction of this report about the State of Missouri which shows the problems that are created if this part of the State Administrator's job is not performed.

adequate and proper support to state and local governments and the political officials in their states.

The GAO report documented problems with the IRS (and SSA) not having sufficient information to properly ensure accurate Social Security and Medicare coverage and FICA tax collection. As noted earlier in this report, however, most of the information they need is readily available from State Administrators.

Information sharing is critical to ensuring proper Social Security and Medicare coverage, public pension system compliance, and FICA tax collection from state and local government employers. The GAO report documented serious problems in the current collaboration and communication among the federal (IRS and SSA) and state (State Administrators) partners. GAO even cited a number of examples of inadequate communication within SSA and the IRS themselves, let alone with State Administrators.

The lack of proper communication about problems that are identified by the IRS during its education/outreach, compliance checks, and examinations, especially proactively, creates the environment that led to the Missouri school district problem described earlier in this report. If the SSA, and particularly the State Administrators, are made aware of problems within certain types of public employers, such as municipalities, they can target their limited resources to properly educate other such employers in their states, thereby ensuring coverage and tax withholding are proper. Currently, due in large part to limitations on sharing information with State Administrators that are imposed by IRC §6103, the IRS will not contact State Administrators proactively to seek their advice and information about potential coverage issues that may exist among public employers in their states.

Training and succession planning by all parties are also vital to ensuring knowledge transfer occurs. Improvement is needed within all three major parties, i.e., the states, SSA, and the IRS. NCSSSA provided the ACT with its analysis of the GAO report[47] which documented how NCSSSA is approaching this issue to proactively deal with the challenges faced by turnover among State Administrators. The ACT recommends that the IRS adopt a similar strategy for its FSLG staff and, as NCSSSA recommended, that training be conducted jointly by the IRS, NCSSSA, and SSA.

The IRS's inability to share information specific to individual examination results with State Administrators is based on its and Treasury Counsel's interpretation of Internal Revenue Code (IRC) Section 6103, regarding disclosure restrictions that Congress placed on the IRS. It is the ACT's understanding that, due to apparent oversight during the drafting process when the 1987 amendments to the IRC were adopted by Congress, IRC Section 6103 was overlooked and failed to name the State Social Security Administrator as a taxing authority for disclosure purposes even though the State Administrator had exercised that responsibility for all Section 218-covered public employers/ employees in the nation from 1951 through 1986. Thus, it is illogical to think Congress intended to have the State

[47] Letter dated March 9, 2011, from NCSSSA President Maryann Motza, sent to U.S. Ways and Means Committee, Subcommittees on Social Security and Oversight, summarizing NCSSSA's analysis of the GAO report recommendations (GAO-10-938).

Administrator excluded from the permissible state officials with whom the IRS can, and should, share tax information. In fact, the data the states have in their possession are of value for the IRS to make proper tax assessments (**see Appendix C**).

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VIII. Recommendations

Since 1987 when the IRS assumed responsibility for collecting the FICA taxes from state and local governments, the State Administrators have been excluded from key discussions and decisions that relate to Section 218 Agreements to which the states and SSA are the sole parties. Section 218 Agreements and modification to that agreement extend coverage to state agencies and institutions within each state and to political subdivisions of the states only if the agreements are executed by the states and SSA.

The IRS is **not** a party to any of those agreements because the agreements are only between the SSA and the states. Yet the IRS plays a large role in that they enforce the Agreements. Because the IRS cannot consult with the states when THEIR Section 218 Agreements are being audited, basic contract law is violated because a principal party to an agreement, i.e., the state, is being excluded from discussions and decisions that directly impact how the terms and conditions of the Section 218 Agreement are enforced by the SSA or IRS.

To overcome this critical flaw, 26 U.S.C. §6103(i) must be amended to name the State Administrator as an appropriate official to which Treasury/IRS can disclose taxpayer (public employer) information.

Other recommendations for the IRS are:

1. The majority of the problems delineated by the GAO report relate to inadequate information-sharing between the IRS and SSA as well as with state officials, i.e., State Social Security Administrators (State Administrators). To properly rectify this problem permanently, changes are needed to 26 United States Code Section 6103,[48] which currently limits information sharing with the SSA and precludes the IRS from discussing coverage and employment tax issues with State Administrators. State Administrators are the responsible officials in each state who administer the voluntary Social Security (Section 218) Agreements entered into between states and the SSA. Their knowledge, expertise on state-specific information, and documentation maintained in their files are invaluable to the IRS's ability to properly assess FICA taxes and determine if public pension system requirements are being met by each employer for all employees.
2. National Conference of State Social Security Administrators (NCSSSA), as the national organization that represents all State Administrators, should be treated by the IRS as a partner in its state and local tax administration activities. The IRS should work closely with the Social Security Administration and NCSSSA to ensure state and local government employers and employees are paying the ***proper*** employment taxes and have the Social Security and Medicare coverage and benefits permissible under federal and state laws.[49] All education and outreach

[48] 26 U.S.C. § 6103.

[49] Accurate assessment of FICA taxes on public employers by the IRS is hampered and more costly to taxpayers if the IRS does not confer with the U.S. Social Security Administration and the appropriate State Social Security Administrator. The State Administrator's records include critical interpretive information from numerous sources, including SSA and the

efforts with public employers, in any state, should be conducted jointly by the IRS, SSA, and appropriate State Administrator.

To ensure accurate and complete knowledge transfer, training of successors to existing staff within the states, FSLG, and SSA (both at the Baltimore headquarters and in the regional offices) should also be conducted jointly, but with NCSSSA representing all of the states because of its role as the sole professional organization for State Administrators.

3. The IRS should confer with NCSSSA on state and local governments' compliance issues and concerns and when interpreting data obtained during compliance checks and examinations, its Section 218 assessment document initiative, and other data analyses recommended by GAO and the Treasury Inspector General for Tax Administration (TIGTA).[50] This is particularly important over the next two to three years because, effective with the June 2011-2012 ACT year, for the first time since the ACT Committee was formed ten years ago, no State Social Security Administrators will be members of the ACT Committee. Without the insights and information that are available from State Administrators about the coverage applicable to the public employers in their states, the IRS will continue to lack the necessary data to properly assess employment taxes on these employers.
4. The IRS/FSLG needs to be proactive in identifying potential issues by enhancing its data-tracking efforts, especially of Social Security and Medicare-related information, and reporting of results to both the SSA and State Administrators. The IRS's response to the GAO's recommendation in this regard is flawed, because the response only discussed the IRS identifying and tracking errors concerning Section 218 Agreements discovered in their compliance processes and sharing the information with SSA to the extent allowable by the disclosure provisions of the Internal Revenue Code.[51] That response ignores the mandatory Social Security and Medicare aspects of the Internal Revenue Code, which are also critical components of the IRS's tax administration responsibilities.
5. IRS/FSLG (and Employee Plans) should work more closely with each other on public pension-related issues because of the importance of mandatory Social Security provision that were enacted, effective July 2, 1991, by passage of the Omnibus Budget Reconciliation Act of 1990.[52]

State's Attorney General's Office, which can dramatically affect which groups of employees for each public employer are supposed to be covered by Social Security and/or Medicare-only, depending on what their particular state law and the Section 218 Agreement (or modification to the agreement) indicates is proper. Thus, to ensure proper assessment of employment taxes, the IRS should actually support and advocate for (with the Treasury Department) a limited change to IRC §6103 to allow the Treasury Secretary and IRS to disclose and discuss taxpayer (government employer) information with State Administrators.

[50] Treasury Inspector General for Tax Administration, *The Federal, State and Local Governments Office Can Improve the Workload Selection Process to Increase Effectiveness*, 2006-10-073 (Apr. 28, 2006).

[51] GAO Report (GAO-10-938), p. 52.

[52] Public Law 101-508, 104 Stat. 1388 (Omnibus Budget Reconciliation Act of 1990).

IX. Appendices

See the separately identified Appendices A, B, and C as follows:

Appendix A: Article entitled "Common Errors in State and Local Government FICA and Public Retirement System Compliance," by Maryann Motza and Dean J. Conder, *Government Finance Review*, August 2009, pp. 48-53.

Appendix B: Memorandum of Understanding Between the Social Security Administration and the Internal Revenue Service for State and Local Government Compliance Issues, 2002.

Appendix C: Onsite Review – Colorado Public Employees' Social Security Program, June 14-15, 2006, conducted by Mr. Ken Anderson, Team Leader, Office of Earnings and Information Exchange, U.S. Social Security Administration.

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Appendix A:

Article entitled "Common Errors in State and Local Government FICA and Public Retirement System Compliance", by Maryann Motza and Dean J. Conder, Government Finance Review, August 2009, pp. 48-53.

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COMMON ERRORS in State and Local Government FICA and Public RETIREMENT System Compliance

BY MARYANN MOTZA AND DEAN J. CONDER

Many state and local government employers and employees are confused by the Federal Insurance Contribution Act (FICA) tax and public retirement system obligations. This employment tax, which is the basis for Social Security and Medicare, is straightforward in the private sector. Applying FICA to state and local government employment, however, can be exceedingly difficult. In addition, the Governmental Accounting Standards Board (GASB) does not test for FICA compliance, which can lead to a false sense of security when a state or local government receives an audit compliance certificate based on GASB audit standards.

The laws and rules that affect public employers' federal FICA tax obligations regarding Social Security and Medicare coverage provisions include numerous exemptions and exceptions to the laws that apply to the private sector. Further exacerbating the situation are the semantics associated with the laws, which can create confusion that results in inadvertent noncompliance:

- "Voluntary" Social Security coverage through a Section 218 agreement was once the only way state and local governments could elect Social Security coverage for their employees. Since April 20, 1983, coverage under a Section 218 agreement cannot be terminated unless the governmental entity is legally dissolved.
- "Mandatory" Social Security coverage is not really mandatory for all state and local government employees. If a public employer has a qualifying FICA replacement retirement system for its employees, it is not required to pay the Old-Age, Survivor, Disability portion of Social Security.
- "Mandatory" Medicare coverage is also not really mandatory for all state and local government employees. It is actually illegal to pay Medicare tax for Medicare-exempt employees. The Medicare-only portion, however, is required for anyone hired by a public employer after March 31, 1986.

If you are not confused yet, you soon will be.

This employment tax, which is the basis for Social Security and Medicare, is straightforward in the private sector. Applying FICA to state and local government employment, however, can be exceedingly difficult.

HOW WE GOT HERE

Congress enacted the Social Security Act in 1935 to establish an insurance program for "persons working in industry and commerce as a long-run safeguard against the occurrence of old-age dependency." Congress, however, faced constitutional questions as to whether it could force state and local governments to include their employees in the Social Security system, so state and local government entities were not compelled to take part. In fact, at that time, public employers were actually forbidden to do so.

Beginning in 1951, states were allowed to enter into voluntary agreements (authorized by Section 218 of the Social Security Act and thus called Section 218 agreements) with the federal government to provide Social Security coverage to their public employees. Each state enacted its own legislation to provide the authorization for the state and its political subdivisions to voluntarily enter into individual Section 218 agreements with the federal government that provided coverage to different classes and positions of employees. These original Section 218 agreements have a provision that allows an entity to withdraw from the agreement, but since 1983, that provision has been overridden by federal law.

With the enactment of the Medicare portion of FICA in 1965, all Section 218 agreements were automatically covered with Medicare. In 1985, Congress enacted what is popularly termed mandatory Medicare. Under this law, anyone hired on or after April 1, 1986, is subject to the Medicare portion of the FICA tax, regardless of whether or not the entity covers its employees by a public retirement system. Those employees covered only by Medicare (and not Social Security) are said to be Medicare Qualified Government Employment (MQGE). The employer is required to file W-2 and 941 forms for each MQGE employee.

In 1990, Congress amended the Internal Revenue Code (IRC) and the Social Security Act, making Social Security and Medicare coverage mandatory for most state and local government employees who were not covered by a qualifying FICA replacement public retirement system or a Section 218 agreement. This law became known as mandatory Social Security, which is different from mandatory Medicare. Medicare is mandatory regardless of the existence of a retirement system, but Social Security is mandatory *only in the absence* of a retirement system or Section 218 agreement.

STATE SOCIAL SECURITY ADMINISTRATOR

States are required by federal regulation to appoint an official as the state Social Security administrator. The state administrator is the person responsible for administering the Section 218 agreements for each state. Until 1987, the state administrator was also responsible for collecting the Social Security and Medicare contributions (now referred to as the FICA taxes) from state and local government employers and to deposit the funds with the United States Treasury. When the Internal Revenue Service (IRS) assumed this function in 1987, many states interpreted this change as eliminating any further responsibilities, but that is incorrect; the majority of functions and responsibilities of the state administrator remain.[1] In fact, the responsibilities have become even more complicated since 1987, with the advent of the mandatory Social Security and Medicare provisions.

The state administrator is often thought of as a bridge between the federal agencies and local entities. Many small local entities do not have the expertise to effectively communicate and respond to the relevant issues, as this area of taxation is extremely complex and changing a single fact can alter a particular outcome. See Exhibit 1 for examples of typical fact patterns that result in vastly different conclusions about an entity's probable tax compliance when seemingly minor additional factors are added to the scenario.

DETERMINING COMPLIANCE

Employee or Contractor? In determining FICA compliance, the first question to ask is if the worker is an employee or an independent contractor. No FICA taxes are withheld for independent contractors; instead, the payment is recorded and filed on IRS Form 1099-MISC.

Is There a Section 218 Agreement In Place? This question can most readily be answered by the state Social Security administrator, whose office is responsible for administering the particular state's master agreement and each individual entity's agreement. Each entity's Section 218 agreement can differ, even within the same jurisdiction.

Coverage under Section 218 agreements can be extended only to groups of employees known as coverage groups. Once a position is covered under a Section 218 agreement, any employee filling that position is permanently covered for Social Security and Medicare. Each entity decides, within federal and state laws, which groups to include under its Section 218 agreement. Federal law excludes certain services or positions from coverage and requires coverage of others. For example, individuals whose compensation is solely fee based are excluded from mandatory coverage under federal law but can be included as optional coverage under an entity's Section 218 agreement.

Does the Entity Have a Qualifying Public Retirement System? State and local government employees must be covered by either a qualifying public retirement system or Social Security, by either a Section 218 agreement or the mandatory provisions of the federal law. (There is, however, new legislation regarding contracts involving goods and services.) Regardless of whether or not employees are covered by a retirement system, the employer is subject to the Medicare portion of the FICA tax for employees hired on or after April 1, 1986. Similarly, it is equally improper to withhold and pay Medicare on an employee who is covered by a retirement system and was hired before April 1, 1986, if that employee is not covered under a Section 218 agreement — unless the referendum[2] procedures are followed.

Finally, not all retirement systems qualify under the Omnibus Budget Reconciliation Act (OBRA) of 1990. If the position is not covered under a Section 218 agreement, an employer can provide an alternative retirement system, so long as it meets IRC requirements. According to Treasury Regulation 26 C.FR. 31.3121(b)(7)-2, a pension, annuity, retire-

Exhibit 1: Complexity Chart — Representative Examples of State and Local Government FICA Issues*

Primary Fact Situation	Additional Relevant Facts (Nuance/Possible Issue)	Probably Non-Compliant	Probably Compliant
Employer is not withholding Medicare on all employees.	If all employees are covered under a Section 218 agreement.	■	
	If all employees are covered under a public retirement system and Medicare is being withheld only from employees hired on or after April 1, 1986.		■
Political entity has stopped paying Social Security and is paying into a qualifying public retirement plan.	If political entity is covered for Social Security under a Section 218 agreement.	■	
	If political entity is covered for Social Security by mandatory Social Security provisions.		■
Political entity has a Section 218 agreement and is not paying FICA.	If entity did not opt out of the agreement before April 20, 1983, it is permanently locked into the agreement and must pay FICA on all covered employees.	■	
	If entity opted out of its Section 218 agreement before April 20, 1983, and its employees are covered by a public retirement system and are paying Medicare, as applicable.		■
Political entity has continuously been paying Social Security and also into a public retirement system for all employees.	Officials erroneously think the entity must pay into a public pension system and into Social Security, believing the requirement is "mandatory" for all public employers since July 1991. No Section 218 agreement exists.	■	
	Public entity voluntarily elected to be double covered by entering into a Section 218 agreement while continuing to pay into a public pension plan.		■

** At least 500 compliance scenarios exist related to state and local government FICA, Social Security and Medicare coverage, and public pension system issues.*

ment, or similar fund or system "is not a retirement system with respect to an employee unless it provides a retirement benefit to the employee that is comparable to the benefit provided under the Old-Age portion of the Old-Age, Survivor, and Disability Insurance (OASDI) program of Social Security." A defined contribution retirement system meets the test provided by this regulation if allocations to the employee's account are 7.5 percent of compensation and do not include any credited interest in the calculation. Matching contributions by the employer may be taken into account for this purpose. Thus, a defined contribution plan that has a contribution rate from the employer, employee, or both that is 7.5 percent of compensation can take the place of the OASDI portion of Social Security under OBRA 1990 (unless of course, the position is

covered under a Section 218 agreement). Mandatory Medicare still must be paid.

What About Rehired Annuitants? State and local employees who are part of a retirement system, were hired before April 1, 1986, and have been continuously employed are exempt from mandatory Medicare. In fact, it is equally incorrect to pay and cover those employees with Medicare. However, in the public sector, many employees who have retired and who receive a pension from their retirement systems are rehired under the retirement system (e.g., retired teachers are rehired as substitute teachers). These employees are called rehired annuitants; they are receiving their annuity, or pension, but they have been rehired — even if only part-time.

This is a common area of confusion within the public sector. One of the requirements for the exemption is continuous employment, and the act of retiring and receiving a pension breaks the continuity of employment. Therefore, any further employment after retirement is subject to the Medicare portion of the FICA tax. Further, if the retirement system does not cover these annuitants, they are subject to full FICA.

The state administrator is often thought of as a bridge between the federal agencies and local entities. Many small local entities do not have the expertise to effectively communicate and respond to the relevant issues, as this area of taxation is extremely complex and changing a single fact can alter a particular outcome.

OBTAINING SOCIAL SECURITY COVERAGE

Although initially the only way for a state or local government employer to have Social Security coverage for its employees was to enter into a Section 218 agreement, this is inadvisable today because of the permanence of the agreement. Instead, current law allows for Social Security coverage of state and local employees under the mandatory provisions discussed above. An entity without a Section 218 agreement is free to choose between pension coverage and Social Security coverage and can move from one to the other, without penalty, by merely withholding (or stopping its withholding) and matching the FICA tax — and, of course, filing appropriate W-2 and 941 forms. Remember, however, that *all* employees, regardless of the type of coverage, hired after March 31, 1986, are required to pay the Medicare portion of FICA.

For employees hired before April 1, 1986, a Section 218 agreement can be executed to provide Medicare-only coverage for employees who are members of a qualifying retirement system and who are not already covered under a Section 218 agreement. Under the majority vote referendum procedures, if a majority of employees vote for Medicare coverage and the entity agrees to match and withhold the Medicare portion of FICA, it is lawful to extend Medicare-only coverage to these otherwise excluded employees.

The referendum process is also available to those employees who want Social Security coverage in addition to their public retirement system. The majority vote referendum process requires a majority of employees eligible to vote in the referendum, rather than those actually voting, to approve the referendum. If the referendum passes, then all pension eligible employees within that entity would have FICA coverage. All states are authorized by federal law to use this referendum process, and 21 states can use another process called the divided retirement system referendum, which in essence allows each employee to elect Social Security and/or Medicare coverage in addition to the retirement system. The procedures are the same except that there are no secret ballots, as the individual choosing coverage must be identified. The election by the individual to be covered by FICA covers the position, not the individual, so all future holders of that position will be covered by FICA.

All referenda are conducted under the direction of the State Social Security administrator under the provisions of federal and state law. Because each state's enabling legislation is unique and provides for difference procedures, the state statutes and the federal law regarding the procedural process must be consulted.

OTHER PROVISIONS: WEP AND GPO

The windfall elimination provision (WEP) affects an employee's Social Security benefit when a person works for an employer that has a public retirement system rather than any form of Social Security coverage. For example, Employee A works in the private sector for at least ten years and is then

employed by a local government that provides a retirement system rather than FICA coverage. In considering Employee A's entire work record, he would qualify for Social Security benefits because he has at least 40 credits. Employee A's Social Security benefit is offset, however, by the formula known as the windfall elimination provision. The formula is complex, and for this article, the important point is that employees need to be aware that if they work in uncovered employment (i.e., their wages are not subject to the full FICA tax), any Social Security retirement benefit might be reduced under this provision of the law.[3]

The WEP provision does not apply to survivor benefits. Other exceptions to WEP are:

- federal workers first hired after December 31, 1983
- retirees who were 62 years of age or disabled before 1986
- retirees who began receiving a monthly public retirement benefit before 1986, but continued to work beyond 1986
- retirees who have 30 or more years of substantial earnings under Social Security.

The government pension offset (GPO) provision is similar to WEP. This provision offsets a retirement benefit claimed on the work record of a spouse or ex-spouse when the employee is covered by a public retirement system. This offset formula reduces the benefit by two-thirds of the amount of the public retirement benefit. In some cases, the offset will eliminate a Social Security benefit entirely. The GPO provision does not apply to a retiree who receives a public retirement benefit based on work that was also covered by a Section 218 agreement for the preceeding five years.

CONCLUSION

This area of taxation and public retirement system requirements for state and local governments can be complex and confusing. During training sessions, the authors often tell audience members that "if you are not confused by the end of the presentation, you have not been paying attention." Likewise, this article is meant only to broach the subject. Readers are encouraged to use the additional resources provided (see the "Additional Resources" box) to further explore the subject.

Additional Resources

- IRS Publication 963, *Federal-State Reference Guide*: http://www.ssa.gov/slge/pubs.htm
- Colorado Public Employees' Social Security: http://pess.cdle.state.co.us/
- National Conference of State Social Security Administrators: http://www.ncsssa.org/
- IRS Federal, State, and Local Governments (FSLG) office: http://www.irs.gov/ (click on "Government Entities"). To keep abreast of developments, you can subscribe to the *FSLG Newsletter* by selecting it from the "Topics" section of this Web site.
- IRS Employee Plans (public pension system requirements): http://www.irs.gov/ep
- Social Security State and Local Government: http://www.ssa.gov/slge/
- State of Kentucky: http://sssa.state.ky.us/

Notes

1. This fact has recently been documented by an issue that arose in the State of Missouri. See the final Task Force Report for a description of the problem and how it had to be addressed by multiple individuals and agencies: M. Grochowski, et al., *Report: Federal Section 218 Task Force for Missouri School Districts*, March 31, 2009, http://oa.mo.gov/acct/033109 FederalTaskForceReport.pdf.
2. A Section 218 agreement is made between the Social Security Administration and a state's Social Security administrator (acting on behalf of the state) to provide coverage for a group of state or local government employees. *A Section 218 agreement covers positions, not individuals.* Coverage under a Section 218 agreement supersedes all other considerations. If a public employer wants to provide both a qualifying FICA replacement plan and full Social Security coverage for its employees, a referendum election must be conducted by the state Social Security administrator (or by the Social Security Administration, if the entity is an interstate instrumentality). Mandatory Social Security coverage ceases for a state or local government employee when he or she becomes a member of a qualifying public retirement system.
3. For details, see Social Security Administration's Web site at http://www.ssa.gov/gpo-wep/.

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Appendix B:

Memorandum of Understanding Between the Social Security Administration and the Internal Revenue Service for State and Local Government Compliance Issues, 2002

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MEMORANDUM OF UNDERSTANDING BETWEEN THE SOCIAL SECURITY ADMINISTRATION AND THE INTERNAL REVENUE SERVICE FOR STATE AND LOCAL GOVERNMENT COMPLIANCE ISSUES

Section 1. Purpose

This Memorandum of Understanding (MOU) specifies the responsibilities of the Social Security Administration (SSA) and the Internal Revenue Service (IRS) with respect to reporting and compliance requirements for state and local government employers under the Social Security Act (Act) and the Internal Revenue Code (Code). This includes specifying the responsibilities of both agencies for performing compliance reviews, educating public employers, and improving the reporting process between SSA and IRS to detect compliance problems.

Additionally, this MOU addresses activities intended to improve the wage reporting of state and local government entities. These specifically include the responsibilities of the IRS and SSA regarding meeting the educational needs of public employers and improving the operational and informational exchanges between the agencies.

Section 2. Background

Public Law 99-509, enacted October 21, 1986, revised Section 218 of the Act and Sections 3121 and 3126 of the Code to transfer from the states and SSA to the IRS responsibility for the collection of Social Security contributions from state and local government employers under Section 218 Agreements. Prior to 1987, the State Social Security Administrators were responsible for reporting covered wages to SSA, collecting the Social Security and Medicare contributions from public employers, and depositing those amounts to the Social Security Trust Funds. Beginning January 1, 1987, state and local government employers became responsible for the reporting and payment of Social Security and Medicare taxes directly to the IRS.

A "Section 218 Agreement" is a written agreement between a state and SSA to provide Social Security and/or Medicare coverage for employees of a state or local government. Beginning January 1, 1951, Section 218 Agreement coverage was available for the services of employees in positions not covered under a retirement system. These

non-retirement system positions are referred to as absolute coverage groups. The Social Security Amendments of 1954, effective January 1, 1955, allowed states to voluntarily extended Section 218 Agreement coverage to the services of employees in positions covered under a retirement system. These groups are referred to as retirement system coverage groups. Since April 20, 1983, coverage under a Section 218 Agreement cannot be terminated unless the state or local government entity is legally dissolved.

In 1986, Public Law 99-272 mandated Medicare coverage for all state and local government employees hired, or rehired, after March 31, 1986. In 1990, Public Law 101-508 mandated Social Security coverage, effective July 2, 1991, for virtually all state and local government employees not covered by either a public retirement system or a Section 218 Agreement.

Section 3.
Responsibilities

The SSA is responsible for the Social Security and Medicare coverage provisions under the Act. The IRS is responsible for the Social Security and Medicare taxation provisions under the Code.

With respect to state and local government taxation issues, under the authority of Chapter 21 of the Code, IRS is responsible for:

- Administering the Federal Insurance Contributions Act (FICA), including the mandatory Social Security and Medicare provisions concerning services performed by state and local government employees;

  Assuring that there is proper reporting and collection of Social Security and Medicare taxes by state and local governments under the FICA through examination and other compliance programs; and

- Interpreting the FICA provisions applicable to state and local governments through published guidance, e.g., Regulations, revenue rulings, and revenue procedures, and through non-precedential advice to taxpayers and IRS personnel, e.g., private letter rulings and field directives.

With respect to state and local government coverage issues, under the authority of Sections 218 and 210 of the Act, SSA is responsible for:

- Making rules and Regulations and establishing procedures, not inconsistent with Title II of the Act (42 U.S.C. 401 et seq.), which are necessary or appropriate to carry out certain provisions of the Act;

- Adopting reasonable and proper rules and Regulations to regulate and provide for the nature and extent of the proofs and evidence and the method of taking and furnishing the same in order to establish the right to benefits under the Act;

  Maintaining and executing Section 218 Agreements and Modifications to such agreements;

  Determining the coverage status of state and local government employees covered under a state's Section 218 Agreement and modifications thereof, and the mandatory coverage provisions under Section 210 of the Act, for Social Security and Medicare benefit purposes; and

- Assuring the accurate crediting of earnings to all workers; maintaining accurate earnings records; verifying the earnings amounts provided; and correcting erroneously posted amounts, as required by law.

Section 4.
Educating State and Local Government Employers

IRS will advise and educate state and local government employers about Social Security and Medicare taxation provisions under the FICA, including those provisions relating to reporting and deposit processes for Social Security and Medicare taxes.

SSA will advise and educate State Social Security Administrators and state and local government employers about the Social Security and Medicare coverage provisions under Sections 210 and 218 of the Act and the Annual Wage Reporting (AWR) process.

IRS and SSA will promote better state and local government reporting practices by conducting periodic joint educational workshops for state and local government employers.

SSA and IRS will review IRS Publication 963, Federal-State Reference Guide for State and Local Government Employers, a multi-agency document published by the IRS, to determine whether a revision of the publication is necessary. New editions of Publication 963, or supplementary publications (additions/deletions), will be created jointly by the IRS and SSA.

Section 5.
Improving the Coordination Process Between IRS and SSA

IRS and SSA agree to implement a standing Section 218 Committee beginning in Fiscal Year 2002 to discuss policy, procedural, and compliance issues relating to Social Security and Medicare coverage and taxation of state and local government employees.

The Section 218 Committee will meet semiannually, or more frequently, if appropriate, to evaluate findings and develop proposals and alternatives for executive decision-making.

The Section 218 Committee will evaluate information exchange methods for data concerning state and local government employers and will periodically provide recommendations for improving the coordination process. As an essential part of this process, the Committee will study the feasibility of perfecting the Section 218 Agreement/Modification information retained in IRS and SSA databases. The Section 218 Committee will consider sharing perfected Section 218 Agreement/Modification data with State Social Security Administrators.

Section 6.
Disclosure of Federal Returns and Federal Return Information

SSA is bound by the provisions of Section 1106 of the Act and Section 6103 of the Code. IRS is bound by the provisions of Section 6103 of the Code.

Section 6103(l)(1)(A) of the Code authorizes the IRS, upon written request, to disclose returns and return information with respect to taxes imposed by chapters 2, 21, and 24 to SSA for purposes of SSA's administration of the Act.

The term "Federal Return" means a "return" as defined in Section 6103(b)(1) of the Code. The term "Federal Return Information" means "return information" as defined in Section 6103(b)(2) of the Code.

Pursuant to the Act, the SSA is charged with responsibility for administration of the Act. Federal Returns and Federal Return Information (whether originals, paper copies, photocopies, microfilm, magnetic media, or any other form) received from the IRS pursuant to Section 6103(l)(1)(A) will be used only to the extent necessary for the purpose of SSA's administration of the Act. Such information shall not be used for the SSA's administration of any other statute.

The term "SSA Representative" means an officer or employee of the SSA designated in writing by the SSA to the Commissioner, IRS, as an individual who is authorized to inspect or receive Federal Returns and/or Federal Return Information with respect to chapters 2, 21, and 24 taxes on behalf of the SSA as provided by Section 6103(l)(1)(A) of the Code, but only so long as the duties and employment of such officer or employee require access to such Federal Returns and/or Federal Return Information for purposes of administration by the SSA of the Act.

Upon the occurrence of any change in employment, duties, or other relevant matters affecting an SSA Representative's authority to access Federal Returns and Federal

Return Information, or status as an SSA Representative, the SSA shall promptly advise in writing the Commissioner or his or her designated representative of such change.

The term "disclosure" means the making known to any person in any manner Federal Return or Federal Return Information. An SSA Representative to whom a Federal Return or Federal Return Information has been disclosed may only disclose such return or return information to another officer or employee of the SSA only to the extent necessary for the purpose of SSA's administration of the Act. Disclosures to contractors and administrators are not allowed.

In accordance with Section 6103 of the Code, this agreement shall constitute a request for the Commissioner, IRS to disclose returns and return information with respect to taxes imposed by Chapters 2, 21, and 24 of the Code to the SSA for purposes of its administration of the Act. Specifically, when the IRS becomes aware of a state or local government employer whose noncompliance with the reporting requirements has resulted in a failure to correctly report employee wages for Social Security purposes, the IRS will provide SSA with the information identifying such entities so, if needed, SSA will be able to contact the employer and obtain the information required to correct employees' earnings records.

Section 7.
Disclosure Safeguards

As an express condition for the inspection and disclosure of Federal Returns and Federal Return Information, the SSA agrees to comply with the safeguards and requirements prescribed by Section 6103(p)(4) of the Code and with such provisions governing implementation of such safeguards and requirements as may be established by Regulations and written procedures; provided by existing Regulations; or contained in IRS Publication 1075, Tax Information Security Guidelines for Federal, State, and Local Agencies.

The SSA will make its officers and employees aware that under Section 6103(a) of the Code, they are required to maintain the confidentiality of Federal Returns and Federal Return Information and that under Section 6103(a)(1), as Federal Officers or Employees, they are prohibited from disclosing Federal Returns or Federal Return Information except as specifically authorized under the Code. The SSA will also make its officers and employees aware that the Code's confidentiality restrictions are enforced by criminal penalties for individuals convicted of willful unauthorized disclosure of Federal Returns or Federal Return Information (see Section 7213 of the Code), criminal penalties for individuals convicted of unauthorized access/inspection of Federal Returns or Federal Return Information (see Section 7213A; and 18 U.S.C. 1030(a)(2)(B)), as well as a civil damages remedy against the United States available to persons whose Federal Returns or Federal Return Information has been unlawfully accessed or disclosed by any Federal officer or employee (see Section 7431 of the Code).

Section 8.
Notices and Contacts

SSA will provide any information required under the MOU to the Director, Government Entities, or to such other person(s) as that Director or the Commissioner, IRS or his designee shall designate. The IRS will provide any information required under this MOU, in accordance with Section 6103 of the Code, to the Deputy Commissioner for Disability and Income Security Programs of the SSA, or to such other SSA Representative(s) as the Deputy Commissioner shall designate.

Section 9.
Funding

Each agency will be responsible for funding the costs it incurs in performing its responsibilities under this MOU.

Section 10.
Effective Date, Modifications and Termination

This MOU will become effective upon signature by the authorized representatives for IRS and SSA. Any modification or amendment of this MOU must be agreed to by both parties in writing and will be effective upon the date of execution or such other date as may be provided in the modification or amendment. This MOU can be terminated by either IRS or SSA upon written notification of the other party at least 90 days in advance of the termination date.

Section 11.
Signatures

Internal Revenue Service
Commissioner,
Tax Exempt and Government Entities

Date: 2-8-02

Social Security Administration
Deputy Commissioner for
Disability and Income Security
Programs

Date: APR - 4 2002

Appendix C:

Onsite Review – Colorado Public Employees' Social Security Program, June 14-15, 2006, conducted by Mr. Ken Anderson, Team Leader, Office of Earnings and Information Exchange, U.S. Social Security Administration

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Onsite Review
Colorado Public Employees' Social Security Program
June 14-15, 2006

The Colorado Public Employees' Social Security Program (PESS) Administrator and I, the Team Leader for Social Security's Office of Earnings and Information Exchange, Coverage and Wages section, mutually agreed to an onsite review of Colorado's records pertaining to Section 218 of the Social Security Act (the Act). The State Social Security Administrator (SSSA) and Deputy SSSA provided me full access to the State's history and document files and folders containing the documents and correspondence related to the provisions of Section 218 of the Act. I reviewed a representative sampling of the myriad types of paper files related to Section 218 of the Act. The folder contents, known within the State as "PESS records", were reviewed in a comfortable, secure conference room. This report addresses these documents and folder contents, along with the Social Security Administration's position on potential document retention processes. I will also provide our position on documents or materials unrelated to the federal mandates and coverage provisions of Section 218, along with Social Security's position on document destruction.

The folders reviewed were primarily related to the State's Section 218 agreement and related modifications, correspondence files, payroll and reporting records and miscellaneous materials. An additional listing of material reviewed is attached to this report.

The ultimate goal of the review was to determine which documents need be maintained indefinitely, regardless of format, e.g., paper (hard-copy), scanned or otherwise digitally reproduced; maintained on a limited basis, and those which can be destroyed. Social Security is pleased to provide guidance on our document retention policies, and to offer considered opinions on materials not directly related to the provisions in Section 218 of the Act.

Document Destruction

In 1986, Congress enacted the Omnibus Budget Reconciliation Act (OBRA) of 1986. Prior to 1987, Social Security was responsible for ensuring that each state paid the correct amount of Social Security contributions for all employees covered under its Section 218 Agreement. Effective 1987, the Internal Revenue Service (IRS) is responsible for the collection of Social Security and Medicare taxes, the verification of the amount owed and the determination that the amount owed has been deposited.

Social Security headquarters in Baltimore, MD maintained an office dedicated to the responsibilities of receiving, reconciling and posting wage reports for state government employees, collecting and reconciling contributions, and adjudicating coverage, as applicable, under a state's Section 218 Agreement. Once the responsibility for collection of the contributions- now FICA taxes- was directed to the IRS, and Social Security's

regional offices assumed the responsibility for coverage under Section 218 agreements, the headquarters offices was disbanded circa 1994. By 1993-1994, that office had reconciled the wage reports, contribution payments, and coverage provisions for most of the 50 states and U.S. territories covered under Section 218 of the Act. Colorado was one of the states reconciled at that time. While there is no statute of limitations on adding wages to a person's Social Security earnings record, and there is the remote possibility that Social Security could communicate with the PESS office regarding delinquent wage reports, there are no plans or apparent reasons to do so. Therefore, we advise that all hard copy records, files, tapes or other media, ledgers and correspondence directly related to wage reports and Social Security contributions for the years prior to 1987 may be destroyed, including:

- SLER (State-Local Employee Report), SLEX (State's List of Exceptions), and SLEE (State's List of Employees) retention & use
- Transmittals and Accounting Reconciliations
- Disk and tape back-ups
- Treasurer Reports and Transmittals
- Audits of entities by the PESS Program or SSA
- Audits of the PESS Program by SSA
- Payroll Unit (PRU) details
- Form 4500s (request by SSA for verification of Social Security/ Medicare contributions paid on behalf of individual employees)
- Summary accounting files: Form 211-71 (Cash Deposited with Treasurer), Form 218-71 (Voucher for Purchases and Services), Form 226-71 (Distribution of Cash Receipts), Form 246-71 (Allotment of Augmenting Revenue Appropriations), Form 304-71 (Unclassified-Between Agencies), Form 305-71 (Transfer of Cash Between Agencies), OAR-S11 (certificate of Deposit), FNB and R83 deposits (contributions from entities), Contributions and Debit S-4 and S-30 (payments to SSA), Debit and Credit DP:O:RS letters and Form OAR-S9a (amount underpaid and overpaid, respectively, to SSA by the State), Forms OAR-S4s (both debit and credit), Forms OAR-S3s (timely received, delinquent, and state interest, penalties, and duplication charges), USD (transmittals to Treasurer by bank) and R83 (cash transmittals to Treasurer by PESS), Form 211-71 (cash deposited with Treasurer), Form 226-71 (Distribution of Cash Receipts), Form 243-71 (Adjustments to Estimated Augmenting Revenue), Form 246-71 (Allotment of Augmenting Revenue Appropriations), Form 304-71 (Unclassified – Between Agencies, Transfers of Cash), Form 305-71 (Transfer of Cash Between Agencies).[1]

At the state's discretion, all correspondence between the PESS office and the payroll, accounting or other internal offices within the state relating to filing or reconciling wage reports, contribution payments, etc. may be destroyed.

[1] List prepared by the Colorado SSSA, 4 -4-2006

Social Security strongly encourages businesses and government offices to use a secure destruction method to destroy any documents or media containing Social Security numbers. Social Security offers the following recommendations, if a contractor is used for document and media destruction:

- Contractors must be responsible for shredding all white and mixed paper and any physical media; and
- Contracts also contain a clause that the state will perform a physical security inspection of the proposed plant, and all personnel involved in handling materials with Social Security numbers will undergo suitability background checks.

Social Security also recommends that the state: ensure(s) sensitive documents do not become mixed with material that have already been shredded; provides written instructions to clarify where employees would place sensitive documents; and properly destroy sensitive material or enter into formal, written agreements with companies performing document destruction services. These agreements, or contracts, may include: 1) a requirement that the contractor provides a certificate of destruction; 2) a statement that document destruction must be witnessed by a state government employee or a contractor employee who meets Federal, State or local government's suitability requirements; 3) provisions requiring adherence to applicable Federal, State and local laws and regulations; and 4) a clause that clearly defines the penalties and ramifications for failure to adhere to contract provisions.[2]

Document Retention/Document Scanning

Section 218 agreements, modifications to the agreements, notices of an entity's dissolution, merger with or an acquisition of another entity(s) are legal, binding contracts with the Social Security Administration. They, along with the State's enabling legislation, referendum certifications, Social Security General Counsel or state Attorney General opinions regarding coverage of positions in the agreement or modifications must be retained indefinitely, or as long as the Agreement is in effect between the state and Social Security. Whether the State's documents are retained in their original paper form or are scanned, and the paper documents either retained or subsequently destroyed, is a determination to be made by the state.

SEC. 205 of the Social Security Act. *[42 U.S.C. 405]* (a)] The Commissioner of Social Security shall have full power and authority to make rules and regulations and to establish procedures, not inconsistent with the provisions of this title, which are necessary or appropriate to carry out such provisions, and shall adopt reasonable and proper rules and regulations to regulate and provide for the nature and extent of the proofs and evidence and the method of taking and furnishing the same in order to establish the right to benefits hereunder. The Commissioner has delegated authority to establish program

[2] Destruction recommendations from the Social Security Administration's Office of Inspector General report "Disposal of Sensitive Documents at the Social Security Administration (Limited Distribution), May 10, 2006. Used with permission.

policies and procedures encompassing Section 218 of the Act to the Deputy Commissioner, Office of Disability and Income Security Programs (DCDISP); further delegated to my office: the Office of Earnings and Information Exchange. Social Security's policy for retention of the agreements, modifications, dissolutions, mergers, etc. documents and correspondence is: "Mark correspondence for **permanent** filing,…" See: https://s044a90.ssa.gov/apps10/poms.nsf/lnx/0104138010!opendocument

Each State which enters into an agreement shall designate the official or officials authorized to act on the State's behalf in administering the agreement (20 CFR Ch. III, § 404.1204); see http://mwww.ba.ssa.gov/OP_Home/cfr20/404/404-1204.htm . The State Administrator acts for the State in maintaining and administering the provisions of the Section 218 agreement. One of the many responsibilities of the State's designee(s) is "Maintains the Section 218 Agreement and its modifications and all intrastate agreements.", see: http://www.ssa.gov/slge/state_ssa.htm . In order for the State Administrator to administer the provisions of the agreement, they must maintain the documents associated with the State's agreement.

Our current policy on paper document retention for Social Security offices maintains that copies of modifications, and by extension the Section 218 Agreements, be kept in locked, fireproof cabinets, see: https://s044a90.ssa.gov/apps10/poms.nsf/lnx/0301505071!opendocument. We have always encouraged the states to do the same. While we recommend safeguarding the documents and files, Social Security does not prescribe filing protocols or file locations for the states, e.g., document storage either on-site (i.e., in the PESS office) or off-site.

Our Office of Earnings and Information Exchange is currently negotiating a contract to have our copies of Section 218 Agreements, modifications, General Counsel opinions and related correspondence scanned. To facilitate rapid and accurate document retrieval, Social Security, in concert with a private contractor, developed a search software database for the scanned documents. The key to rapid document retrieval involves keyword entries in to the database, e.g., the state name, modification number, some or all of the coverage groups included in the modification, or position names. While our office has participated in demonstrations on how the final process will "behave" using preliminary data and a representative sample of scanned material, the project is not complete; therefore, I am unable to provide an analysis of the project or a recommendation for our particular scanning and retrieval methods.

Circuit courts accept copies of scanned document images as legal documents, equivalent to original paper documents with "wet", or ink, signatures. Social Security plans to destroy the documents we scan. However, before we would encourage a state to follow our scanning and retrieval protocols, we would recommend that each state obtain an Attorney General opinion on the validity of scanned document copies in their courts.

Mr. Joe Lambert, Deputy Executive Director, Colorado Department of Labor and Employment, asked me whether Social Security would be willing to share with the states our search software and database protocols. I posed his request to the Director,

Information Technology Support Staff, DCDISP. We see both cost and immediate-use benefits to the states using Social Security's search software. Social Security will provide Colorado with the search software. However, there are technical, security, liability, licensing and support issues: the Colorado State government would have to provide its own infrastructure to support the software, i.e., acquire the Lotus Domino (document management system) platform; purchase a server; purchase licensing agreements from IBM; consent, though a memorandum of understanding document, that the State agrees the search software would be self-maintained, that Social Security would not provide any in-house service or expertise and Social Security would require a security agreement with Colorado's government officials. Other considerations may be required. You may wish to visit the International Business Machine's web site for free Lotus Domino downloads at: https://www128.ibm.com/developerworks/lotus/downloads/ .

Respectfully submitted,

/s/
Ken Anderson
Team Leader,
Office of Earnings and Information Exchange
Social Security Administration

Attachment

Documents Reviewed, and "What constitutes proper maintenance of the PESS records?"

Using the Colorado's SSSA Preliminary List of Questions[3], I have added Social Security's comments or opinions for each individual item:

Section 218 Entities' Files (current number = 767; new entities may be added if Medicare-only referenda are approved in the future).

1) What document(s) contained in each entity's §218 Agreement/ correspondence file (including the State of Colorado's Master 218 Agreement with the SSA) must be maintained indefinitely?

   (a) The official "State-Federal Agreement" for the State and each "Plan and Agreement" entered into on behalf of each political subdivision?
   Maintained indefinitely; see authority on page 3.

   (b) The State's legislative authorization or political subdivision's ordinance or other authorizing document pertinent to the entity requesting Social Security or Medicare coverage for their employees?
   Same as (a) above

   (c) Modification(s) to the State's Master 218 Agreement that relate to each entity?
   Same as (a) above

   (d) Various pieces of correspondence and rulings by the SSA, the IRS, State Administrator, Colorado Attorney General, and so forth, as to proper coverage for each group of employees within each entity, and the FICA taxes that must be paid the entity and employees? If some of these documents can be discarded and others must be retained, each particular piece of correspondence and ruling will need to be identified so all similar records in other files are handled in the same manner.
   Correspondence and rulings as to the proper coverage of positions must be maintained indefinitely; correspondence and rulings on FICA tax payments are "state discretion"[4] regarding destruction or retention. The Internal Revenue Service has jurisdiction on tax payments.

   (e) Records updates distributed to the entities by the PESS Office and the responses received from the entities?
   Updates regarding coverage should be maintained indefinitely; others: state discretion

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[3] Lists of documents and questions prepared by the SSSA, 4-4-06

[4] "State discretion" is defined as the Colorado Department of Labor and Employment office's decision as to whether documents will be kept in hard-copy form; documents are scanned or archived in another media, and then the hard-copy documents destroyed; or the documents are destroyed.

(f) Audit records on each entity, including findings that need to be followed-up on by the PESS Program?
State discretion

(g) Other miscellaneous documents not otherwise identified above? If some of these documents can be discarded and others must be retained, each particular piece of correspondence and ruling will need to be identified so all similar records in other files are handled in the same manner.
Miscellaneous documents not pertaining to coverage, including but not limited to PESS correspondence to or from the state treasury, agreements to extend the statute of limitations on contribution payments, correspondence files with Social Security, referendum certification supporting documentation, are "state discretion"

2) Must the Modifications to the State's Section 218 Agreement be maintained indefinitely?
Same as (a) above

3) Dissolution of Section 218 entities to avoid FICA is illegal under Federal law, so the PESS Program receives regular reports and court filings from the Colorado Department of Local Affairs (DOLA), which is responsible for monitoring and tracking all political subdivisions throughout Colorado. Also, periodically the Colorado General Assembly and Governor propose State legislation that violates Federal laws, so we need to monitor all applicable changes to State laws to prevent such breaches of Federal law.

Can these records be scanned and the original documents destroyed?
State discretion

E. **Non-Section 218 Entities** (current non-Section 218 entities total 1,871; this number changes annually, as state and local governments are periodically created, consolidated, and dissolved. This category also includes quasi-governmental, intergovernmental entities, and public pension systems, such as PERA and FPPA.)

1) Pursuant to Section 210 of the U.S. Social Security Act, the PESS Program must ensure non-Section 218 entities comply with, for example, mandatory Medicare, mandatory Social Security, employment tax withholding, fringe benefits, employee classification, and public pension plan requirements, and all other applicable Federal and State laws, rules, regulations and guidelines (i.e., Social Security Act, Internal Revenue Code).

(a) Are we required to monitor and track creation, dissolution, and consolidation of political subdivisions in Colorado?

Yes; see Social Security's Program Operations Manual System (POMS) sections SL 40001.475-.485.

(b) If we are required to do so, can these records be scanned and then destroyed?
State discretion

2) The PESS Program has not been collecting and maintaining SSA 1945 forms (Statement Concerning Employment in a Job Not Covered by Social Security) from the State of Colorado and its political subdivisions.

(a) Should we be collecting and maintaining those records?
No (unless the PESS Programs also oversees the State's pension plan); see: www.socialsecurity.gov/form1945 .
(b) If we should be collecting and maintaining those records, can they be stored electronically, rather than in hard-copy form?
(c) If we should be collecting and maintaining those records, what retention schedule should be followed?

F. **Interpretive Files and Documents** (applies to both Section 218 and non-Section 218 entities). Many of the records maintained by the PESS program include legal interpretations by the State Attorney General or U.S. officials of issues that have been initiated by the SSA; the IRS; State agencies, departments, or institutions of higher education; or political subdivisions or coverage groups throughout the State of Colorado. For example, the State's District Attorneys, Town Marshals, Election Workers, and proper handling of "sick-pay" were issues that crossed entity-lines for which documentation is maintained by the PESS office because the issues are revisited periodically by political officials in the State and at the national level. Without the records being available in some form or another (i.e., hard copy or electronically), administrative and legal costs would be high by us having to revisit these previously disputed, and resolved, matters.

As an alternative to maintaining the hard-copy files, can these records be scanned and then destroyed?
State discretion

G. **Training Materials and Other Reference Files and Documents** (applies to both Section 218 and non-Section 218 entities). These include all other PESS Program files, records, and documents not otherwise listed above. For example, all legal reference materials (copies of applicable Federal and State of Colorado laws, rules, regulations, etc.); sample materials from past PESS training and outreach efforts that are used as prototypes for future training and outreach programs; National Conference of State Social Security Administrators (NCSSSA) proceedings and correspondence (historical reference material and policy decisions); PESS FICA brochure and other materials developed by the PESS Program to educate and inform state and local government employers and

employees about their legal obligations; PESS website; and any other documents, records and files associated with PESS Program systems and operations.

As an alternative to maintaining the hard-copy files, can these records be scanned and then destroyed?
State discretion

H. Are there other records that the PESS Program should be maintaining that are currently missing from our files?
None were identified during the review.

I. What other PESS policies, procedures, or practices need to be developed or improved?
None were identified during the review.

J. Should any or all of the findings from the onsite review be incorporated into the training program that Dean Conder is developing for all PESS-related matters?
This is a PESS issue. Social Security always encourages training programs but declines to opine on this question.

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Evaluation of, and Recommendations for Improvement to, the Federal, State and Local Governments (FSLG) Website

Patricia Phillips
Maryann Motza
Paul Carlson
FSLG Project Team

June 15, 2011

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Table of Contents

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I. Executive Summary

A. Overview of Report

The principal goal of this project undertaken during 2010-2011 by the Federal, State and Local Governments (FSLG) Subcommittee of the Internal Revenue Service's (IRS) Advisory Committee on Tax Exempt and Government Entities (TE/GE) (ACT) was to respond to the IRS Federal, State and Local Governments (FSLG) office's request to review the IRS/FSLG website to ascertain if it was meeting its intended goals and how it is being perceived and utilized by federal, state and local governments. The FSLG has expended considerable time and resources in developing their website and the ACT applauds them for reaching out to the public in this manner.

B. Principles

The ACT adhered to the following principles while completing this project:

- The ready availability on-line of important information about the IRS's FSLG office has an immediate, positive impact on taxpayers.

- The stakeholder feedback obtained by the ACT FSLG Subcommittee members can benefit the IRS/FSLG office by providing the user perspective on the value of the website, including possible areas for improvement.

C. Recommendations

The ACT recommends that the IRS review the www.surveymonkey.com data (**Appendix A**) and this report of those findings and implement appropriate suggestions for improvement. The combination of information will enable the FSLG office to refine and improve its website to provide even more valuable services to its customers in the future.

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II. Introduction and Justification for Project

The office of Federal, State and Local Governments (FSLG) supports the IRS and the Tax Exempt and Government Entities (TEGE) division strategic goals of:

1. Enhancing Enforcement of the Tax Law;
2. Enhancing Taxpayer Education and Outreach; and
3. Modernizing the IRS through its People, Processes and Technology.

In support of these goals, two of the major work plan areas during the 2010-2011 fiscal year for FSLG were to encourage voluntary compliance by government entities and meet customer needs.[1] This ACT project provides feedback to the IRS/FSLG office on how it can help accomplish both of those work plan areas. It is mutually advantageous to both the IRS and the taxpayers (including federal, state, and local "public" employers) for the IRS to make access to information about its programs and practices as easy to find and use as possible.

[1] FY 2011 Federal, State and Local Governments Work Plan (October 1, 2010): http://www.irs.gov/pub/irs-tege/fslg_fy11_work_plan.pdf.

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III. Background and Project History

In June 2010, the IRS/FSLG officials asked members of the ACT (FSLG Subcommittee) to review the FSLG website (available at: http://www.irs.gov/govt/fslg/index.html) and provide them with feedback on the value of the site to its customers (i.e., all federal, state, and local government employers and their legal and financial advisors), including any areas for improvement. To accomplish this task, the ACT members met with Mr. Stewart Rouleau, FSLG Senior Analyst, who manages the content of the FSLG website. During the October 2010 ACT meeting, Mr. Rouleau conducted a demonstration of the FSLG website for ACT members and answered questions, such as why things were organized in the manner they are, why descriptors for the links are limited in their length, and so forth. He explained that some of the content is centrally directed by the IRS and other things are within FSLG's control.

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IV. Evaluation Process

With the background on the FSLG website, noted above, the ACT members formulated a survey to be distributed to FSLG's customers. Because FSLG cannot contact public employers directly for such surveys, the National Conference of State Social Security Administrators (NCSSSA) graciously agreed to serve as the host website for the ACT/FSLG Subcommittee's evaluation of the FSLG website.[2] See **Appendix B** for the information that was posted on the NCSSSA website at http://www.ncsssa.org/whatsnewcombo.html, soliciting feedback for this ACT survey.

The survey (using the www.surveymonkey.com on-line tool) asked FSLG's customers to assess the website's usefulness and value. The survey was directed to federal, state, and local governmental ("public") employers and their legal and financial advisors as well as public employees. The survey was open from December 1, 2010, (when it was first posted on the NCSSSA website) to March 13, 2011.

The survey announcement was publicized widely to FSLG customers, using a number of avenues:

- **American Payroll Association** publicized it to their membership.
- **NCSSSA**, in addition to hosting the survey on its website, publicized it to its members (State Social Security Administrators) and asked them to encourage the state and local governmental employers/employees in their state to complete the survey.
- **Government Finance Officers Association** (the international association) and the **Commonwealth of Virginia GFOA** publicized it to their membership through various means, including newsletters and posting the announcement on their websites.
- **IRS/FSLG** publicized it by including an article written by the ACT (see **Appendix C**) in its January 2011 newsletter to which public employers subscribe. The IRS cannot access the list of newsletter subscribers, due to disclosure and other restrictions, so direct contact with the FSLG's list of newsletter subscribers was not possible.

[2] NCSSSA officials hosted the survey of public employers for this ACT project. Last year, NCSSSA also hosted the pretesting of the Compliance Self-Assessment tool that was conducted by the ACT. The ACT cannot have the IRS host surveys of its customers because the Paperwork Reduction Act of 1995 requires that Federal agency information collections employ effective and efficient survey and statistical methodologies appropriate to the purpose for which the information is to be collected. It further directs the Office of Management and Budget (OMB) to develop and oversee the implementation of Government-wide policies, principles, standards, and guidelines concerning statistical collection procedures and methods.

See http://www.whitehouse.gov/OMB/inforeg/pmc_survey_guidance_2006.pdf for details. That restriction prohibited the IRS from hosting both the pretest last year and the survey this year asking for feedback about the FSLG website.

- **National Association of State Auditors, Comptrollers and Treasurers (NASACT)** publicized it to their membership through various means, including newsletters and posting the announcement on their websites.

The survey focused on wanting to achieve the goals of improving transparency, education, and efficiency. To accomplish those goals, the survey sought feedback on:

- Is the IRS/FSLG Website being used?
- Is it helpful?
- Can it be further improved?

Thus, the survey asked 13 questions (including optional contact information), such as: if federal, state, and local governments knew about the website; if they used it, was useful; and what would make the FSLG website a more useful tool for the users. Both the survey questions and answers that were provided by people who responded to the questionnaire are contained in **Appendix A**.

V. Survey Results

From the responses received, the ACT concluded that the website is making a difference to the users and helping them understand both simple tax laws and some very complex tax issues, such as the Section 218 (voluntary Social Security/Medicare coverage) Agreements, which is discussed in a separate project in this report by this ACT FSLG Subcommittee.

A total of 80 people responded to the survey, with 82.5 percent of the respondents indicating they had used the FSLG website previously. Most of the respondents agreed or strongly agreed with each of the following survey questions about the IRS/FSLG website (question number 3, in **Appendix A**):

- It is well organized
- It is clear and understandable
- It is a valuable tool for keeping apprised of federal requirements for employment tax obligations for public employers
- It has helpful headings and links

Most people used it at least once a month (55.4 percent) and 16.9 percent use it weekly or daily. The following portions of the website were considered to be the most beneficial:

- Fact Sheets
- FSLG Newsletter
- Public Employers Toolkit
- Section 218 Information
- Educational Products
- Forms
- Webinar Postings
- Tax Exempt Bonds Updates
- Search Engine

The vast majority of respondents indicated they are likely or very likely to use the website in the future, with only 1.3 percent of the people responding indicating they are “not likely” to use it in the future (question number 4, in **Appendix A**). Even more telling, however, is the number of people who said they are likely to recommend the website to someone else -- 88.2 percent of the respondents indicated they were “likely” or “very likely” to recommend it to others. Thirty-seven of the respondents took the time to provide details on the area(s) of the website that are most beneficial to them, while 24 people provided suggestions for improvements to the site.

The responses came from a variety of government entities from all over the country. There was a broad range of states, counties, municipalities, higher education, and K-12 schools that responded. Unfortunately, no federal employers responded although one defense contractor took the survey. There were large entities and small entities, many with less than a thousand employees (38 percent of the respondents), ranging up to some with over 15,000 employees (16.9 percent). The people completing the survey included a variety of

FSLG's customers, including State Social Security Administrators, Finance Directors, and Accounting and Payroll Clerks. Also, people who responded came from a wide range of years of experience, i.e., from one year to 39 years.

A further analysis of the results of the survey is shown at the end of this report in the conclusions and recommendations section. Briefly, the survey itself results indicated that most responders liked the website and found it was very helpful to them. One person stated he/she "Could not do my job without it." Another person said "We refer people to it all the time." The survey also was somewhat of an educational tool in that one person stated: "Didn't know it existed. Will take a look at it." And the best compliment was one that said "Most of all, thanks for asking for our opinion, it shows us that you are willing to make things better."

The survey also included some very helpful comments on how to make the website even better. The specific suggestions for improvement were:

1. More FAQ's/ greater detail
2. Links to Pub 963 on main page
3. More FACT SHEETS/more topics
4. Charts by State – based on Section 218 Agreements
5. Sheets that can be given to employees, retirees, etc. about how they are subject to social security taxes
6. If… then examples
7. Publication like California benefit taxable chart
8. Special section for K-12 schools – they are different from colleges and universities
9. Self-service training classes (with CPE credit) like State of Colorado Department of Revenue
10. "Question of the Month"
11. Topics/Heading like "training" and "employment tax"
12. Dedicated newsroom
13. Impact of President Obama's healthcare on government/education
14. Index (by date and topic) of Internal Revenue Bulletins
15. Separate way to find forms
16. Place to post questions and have sent to IRS agent
17. List of Phone Numbers and Emails
18. Forms, publications for only Public Employees

Further information which may be helpful related to the suggestion that email addresses and telephone numbers of specific IRS personnel be provided so the government workers can get their issues resolved in a timely manner. This would avoid the person being put on hold for a long period of time and then getting transferred from one person to another before finally becoming exhausted and giving up on ever getting an answer. This last issue is one that the ACT members have heard many times, i.e., that state and local government workers need specialized help.

VI. Special Thanks

The ACT/FSLG Subcommittee wants to specifically thank a few people and organizations that provided invaluable assistance to us on this project. The people and organizations are listed alphabetically:

- **Ms. Loretta Brown**, Executive Assistant, Finance Department, City of Virginia Beach, Virginia. Ms. Brown's assistance was invaluable to the Subcommittee during the evaluation phase of the project. She created the survey-monkey form, addressed issues about how to complete the form from end-users, monitored the survey responses, and provided the final survey results to the ACT members for analysis. In addition, Ms. Brown created the Power Point slides that the subcommittee will use during the public meeting.

- **Mr. Dean J. Conder**, Deputy Colorado State Social Security Administrator, who provided invaluable assistance in helping proof-read this and other ACT/FSLG Subcommittee reports.

- **Ms. Tammy Taylor**, Website Manager, Division of Local Government Services, Social Security Coverage and Reporting Branch, Commonwealth of Kentucky. As noted earlier in this report, the NCSSSA website hosted the ACT/FSLG surveys that were conducted the past two years, largely because one of the leaders of NCSSSA (Maryann Motza) was also a member of the ACT Committee. The future viability of having NCSSSA host other such valuable stakeholder surveys may be in jeopardy because, beginning with the June 2011-2012 ACT year, for the first time in the ACT's 10 year history, the FSLG Subcommittee of the ACT will not have any NCSSSA members.

- **Mr. Paul Marmolejo**, current IRS/FSLG Director, and **Mr. Stewart Rouleau**, FSLG Specialist, who used the FSLG Newsletter e-list and website link (http://www.irs.gov/govt/fslg/index.html) to help the ACT publicize the survey.

- **Ms. Karen Park** (State Social Security Coordinator, State of Oregon), **Ms. Linda Yelverton** (Social Security Program Director, State of Louisiana), and other State Social Security Administrators throughout the country who distributed information about the survey to public employers in their states and helped promote distribution of the survey by fellow State Social Security Administrators.

Several professional organizations were also extremely helpful by providing outreach to their members by publicizing the survey:

- American Payroll Association
- Government Finance Officers Association
- National Conference of State Social Security Administrators
- National Association of State Auditors, Comptrollers, and Treasurers

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VII. Conclusions and Recommendations

The conclusions and recommendations of the ACT related to the FSLG website and this project are:

1. The survey found that 82.5% of the responders have used the website. This maybe have been expected, in that those that had never heard of the website or even tried it could very easily have passed on responding to the survey, because the ones who did respond are very likely those who would have used the website. Nonetheless, an overwhelming number of those who did respond had very good things to say about the website. Over half of the responders use the website at least once a month, 73% stated the website was a valuable tool, and over 60% stated the site was well organized, clear and understandable. Two thirds are likely to continue to use the site in the future and to recommend the site to others. Many responses commended the website made it possible to find out much needed information from Fact Sheets, FAQs, newsletters and links. Specific positive comments were documented earlier in this report.

2. Almost 20% of respondents did not know of the site, so further work needs to be done by the IRS/FSLG office to publicize the site.

3. The IRS should review the entire report, including comments and suggestions for improvement and evaluate and implement as many suggestions as possible. For example:

    a. Consider publicizing recent changes to the website using social media, e.g., Twitter, podcasts.

    b. Include a link on its website to get suggestions for improvement to the website or areas of content included on the site from people who use the site. Tax Exempt Bonds, Exempt Organizations, Employee Plans, and Indian Tribal Governments may benefit from similar evaluations and inclusion of the option for getting stakeholder suggestions about their websites.

    c. While many comments were received as to the help provided from Fact Sheets and newsletters, there were also many comments that the FSLG needs to expand these helpful tools and keep improving them. Suggestions were made to greatly expand FAQs and to categorize them into areas of tax issues. Furthermore, all such tools could be more helpful if they were all dated, stating when the last time they were modified or changed, and to add an index page showing all the recent changes to the website, regardless of the topic. This page could also be used to announce recent tax changes that affect ACT stakeholders, such as the recent elimination of the Making Work Pay credit. While such change affected all taxpayers, having such information on one website would make it much easier to keep up to date. That way a reader could periodically go directly to that page to see “what’s new” and see any status updates. Another related suggestion was to improve links so readers could find

the desired information faster. Navigation in the website was cited by some as not easy to follow, especially when using IRS language and not the words a layman might use. Additionally, answers to questions often times only led the reader to additional publications without actually answering the query.

d. There were a number of comments asking that the FSLG provide a list of all FSLG agents, their phone numbers and their emails, so stakeholders can obtain answers to issues much more quickly. Providing such information for other IRS agents outside of FSLG (such as those with very specific tax knowledge) to help solve issues was also requested. Responders really want a place to get quick and authoritative answers, such as an email address where they can post a question and get an answer back in a matter of hours, not weeks. Phone numbers of IRS agents with specific tax knowledge would also be welcomed. Since we are all public employees, such timely and expedited help is expected.

e. Other improvements to the website included an expansion of the website so that specific entities, such as state governments, higher education, K-12 systems, and municipalities would all have their own section of the website, which would cater to the specific problems of those groups of governmental taxpayers. There would, of course, be links to common sites, but those people would only have to go to one site. A related suggestion is that the FSLG create specific publications that are for just FSLG stakeholders. Again, the purpose of this is to expedite the problem solving workload of such stakeholders.

4. The on-line survey tool that the ACT used to collect and tabulate the evaluations of the FSLG website is an efficient and effective means to obtain valuable feedback from ACT's stakeholders. The costs to use the tool are modest plus it is easy to use – both from the perspective of the responder and the ACT. The ACT members recommend using that on-line tool whenever the ACT needs stakeholders' opinions. Having SurveyMonkey hosted on another site (e.g., NCSSSA) is limiting, so the IRS should seek approval from the Office of Management and Budget to approve an exception to the survey guidance that prohibits the IRS from conducting such surveys (see footnote 2 of this report for details). This tool could be seen as a way to create a focus group for information and input on IRS issues.

5. FSLG must continue to improve the website and ask for stakeholder feedback. It needs to more widely publicize the website, especially when the FSLG produces its webinars, which has been a great new tool for the FSLG. By encouraging all participants on the webinars to use the website, it will greatly help the stakeholders keep better informed. The FSLG knows who its stakeholders are, but it needs to find a way (preferably electronically to keep the costs down) to reach out individually to such entities and keep them informed of new topics, tax law changes and updates to current publications. While continuing the use of the web, consider other useful tools such as podcasts and similar approaches as the IRS continues to evaluate ways to reduce costs while improving compliance. This approach should create capacity for greater emphasis on trends and focused research on areas of non compliance.

VIII. Appendices

See the separately identified Appendices A, B, and C, as follows:

A. Questionnaire Regarding the Federal, State and Local Governments Website—SurveyMonkey Reports of Survey Results

B. Website Posting of Questionnaire Regarding the Federal, State and Local Governments Website

C. Article in the IRS/FSLG Newsletter Related to the Questionnaire Regarding the Federal, State and Local Governments Website

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Appendix A:

Questionnaire Regarding the Federal, State and Local Governments Website – SurveyMonkey Reports of Survey Results

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Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

1. Have you used the IRS/FSLG website before?

	Response Percent	Response Count
Yes	**82.5%**	**66**
No (go to Question #3)	15.0%	12
Don't know (go to Question #3)	2.5%	2
	answered question	**80**
	skipped question	**0**

2. If you answered "yes" to Question number 1, how often have you used the IRS/FSLG website?

	Response Percent	Response Count
Less than once per month	**44.6%**	**29**
monthly	38.5%	25
Weekly	13.8%	9
Daily	3.1%	2
Comments (please specify the approximate number of times you have accessed the FSLG website in the past 12 months)		31
	answered question	**65**
	skipped question	**15**

3. Please answer the following about the IRS/FSLG Website:

	1 - Strongly Disagree	2 - Disagree	3 - Neutral	4 - Agree	5 - Strongly Agree	Response Count
It is well organized	2.7% (2)	10.8% (8)	27.0% (20)	**52.7% (39)**	6.8% (5)	74
It is clear and understandable	1.4% (1)	6.8% (5)	28.4% (21)	**58.1% (43)**	5.4% (4)	74
It is a valuable tool for keeping apprised of federal requirements for employment tax obligations for public employers	1.4% (1)	5.4% (4)	20.3% (15)	**47.3% (35)**	25.7% (19)	74
It has helpful headings and links	1.4% (1)	5.4% (4)	25.7% (19)	**55.4% (41)**	12.2% (9)	74
					Comments	19
					answered question	**74**
					skipped question	**6**

4. How likely are you to use the FSLG website in the future? Not Likely = 1; Very Likely = 5

		Response Percent	Response Count
1		1.3%	1
2		3.9%	3
3		14.5%	11
4		15.8%	12
5		**64.5%**	**49**
		Comments	7
		answered question	**76**
		skipped question	**4**

5. How likely are you to recommend the FSLG website to someone else? Not Likely = 1; Very Likely = 5

	Response Percent	Response Count
1	3.9%	3
2	7.9%	6
3	22.4%	17
4	18.4%	14
5	**47.4%**	**36**
	Comments	7
	answered question	**76**
	skipped question	**4**

6. Please indicate which area(s) of the website are most beneficial to you.

	Response Count
	37
answered question	**37**
skipped question	**43**

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Count
	24
answered question	**24**
skipped question	**56**

8. Please provide any general comments.

	Response Count
	16
answered question	**16**
skipped question	**64**

9. Type of Government

	Response Percent	Response Count
County	18.3%	13
Institution of Higher Education	11.3%	8
Municipal	**19.7%**	**14**
School district (K-12)	18.3%	13
Special district	4.2%	3
State	16.9%	12
Other (please specify)	11.3%	8
answered question		**71**
skipped question		**9**

10. Please indicate the approximate number of employees according to the following categories:

	Response Percent	Response Count
Under 1,000	**38.0%**	**27**
1,001 - 3,000	19.7%	14
3,001- 6,000	8.5%	6
6,001 - 10,000	8.5%	6
10,001 - 15,000	8.5%	6
Over 15,000	16.9%	12
	answered question	**71**
	skipped question	**9**

11. Title of Person who completed this questionnaire.

	Response Count
	69
answered question	**69**
skipped question	**11**

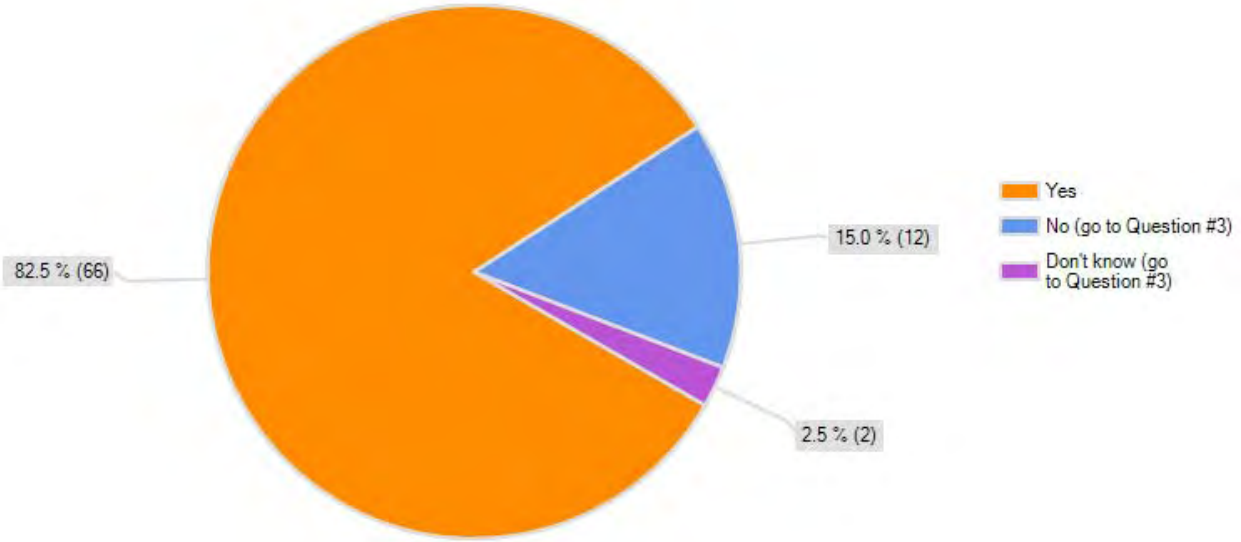
12. Years of experience in this position (please specify).

	Response Count
	70
answered question	**70**
skipped question	**10**

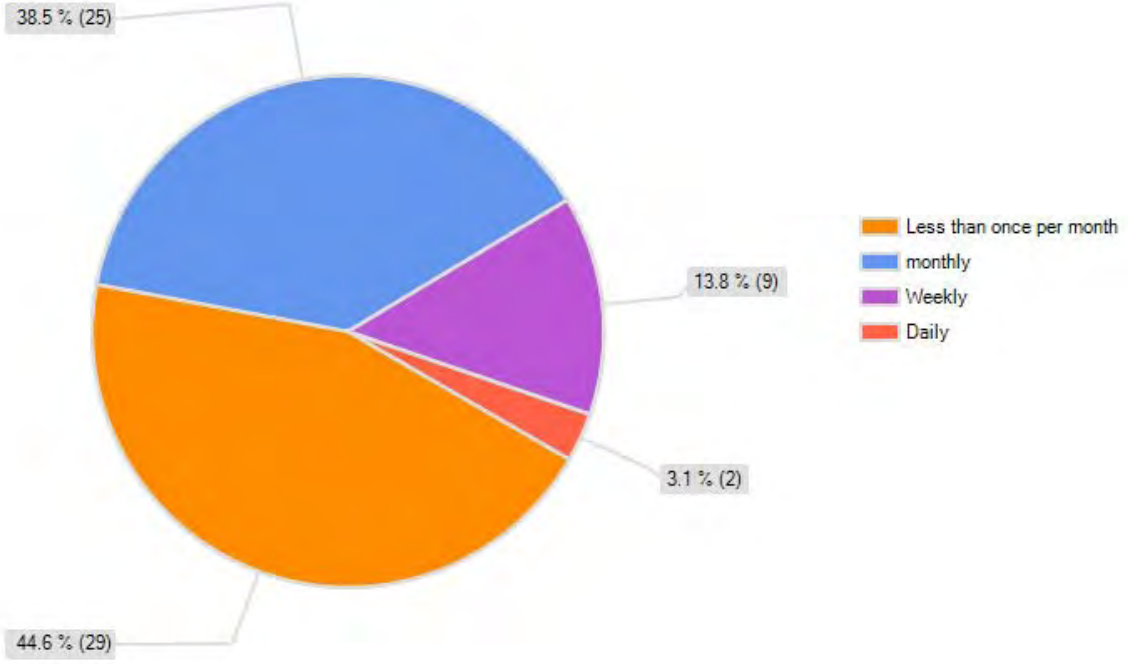
13. Optional: Name and contact information of person completing the questionnaire.

	Response Percent	Response Count
Name:	88.6%	31
Company:	88.6%	31
Address:	77.1%	27
Address 2:	11.4%	4
City/Town:	82.9%	29
State:	**94.3%**	**33**
ZIP:	82.9%	29
Country:	74.3%	26
Email Address:	85.7%	30
Phone Number:	77.1%	27
	answered question	**35**
	skipped question	**45**

1. **Have you used the IRS/FSLG website before?**



2. **If you answered "yes" to Question number 1, how often have you used the IRS/FSLG website?**



Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

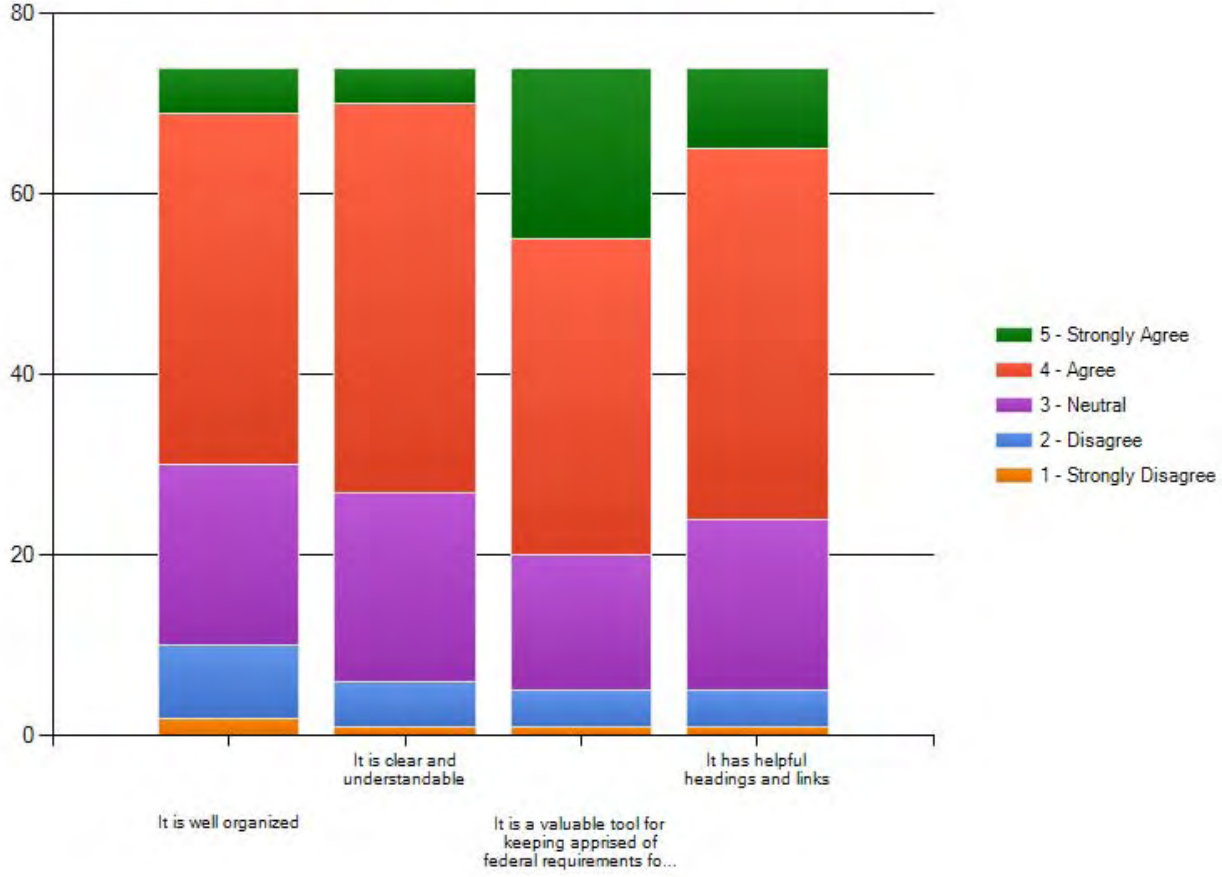
3. Please answer the following about the IRS/FSLG Website:

	1 - Strongly Disagree	2 - Disagree	3 - Neutral	4 - Agree	5 - Strongly Agree	Response Count
It is well organized	2.7% (2)	10.8% (8)	27.0% (20)	**52.7% (39)**	6.8% (5)	74
It is clear and understandable	1.4% (1)	6.8% (5)	28.4% (21)	**58.1% (43)**	5.4% (4)	74
It is a valuable tool for keeping apprised of federal requirements for employment tax obligations for public employers	1.4% (1)	5.4% (4)	20.3% (15)	**47.3% (35)**	25.7% (19)	74
It has helpful headings and links	1.4% (1)	5.4% (4)	25.7% (19)	**55.4% (41)**	12.2% (9)	74
					Comments	19
					answered question	**74**
					skipped question	**6**

	Comments	
1	The website is well organized and has a lot of information	Dec 1, 2010 2:23 PM
2	We can usually get to what we need.	Dec 1, 2010 4:45 PM
3	Easy to navigate. If the document I am needing is not found in the menus, it can easily be found using the search function.	Dec 2, 2010 5:28 PM
4	Not everyone is an IRS guru. Language used by the IRS, on both the website and publications, needs to be put into layman's terms.	Dec 13, 2010 12:18 PM
5	it would be nice to have more government entity related answers. possibly a bulletin board where previous questions can be displayed.	Dec 15, 2010 2:38 PM
6	I have not used it.	Jan 4, 2011 9:52 AM
7	ANSWERING "NO" TO QUESTION #1 (HAVEN'T USED THE WEBSITE) SENDS YOU TO THIS QUESTION THAT ASKS ABOUT THE WEBSITE. NOT WELL THOUGHT OUT - IF ONE HAS NOT USED THE SITE, YOU CAN'T ANSWER #3.	Jan 4, 2011 10:37 AM
8	Sometimes all I want is a quick answer without trying to figure out what publication to find the information in. When I enter search criteria, I receive all sorts of other unrelated and outdated information.	Jan 12, 2011 2:11 PM

	Comments	
19	Very useful website. Am very glad it is available.	Feb 11, 2011 10:55 AM
	could trigger my visits to this site for more information. I don't feel the "search box"	

3. **Please answer the following about the IRS/FSLG Website:**



Questionnaire Regarding the Federal-State-Local Governments Website

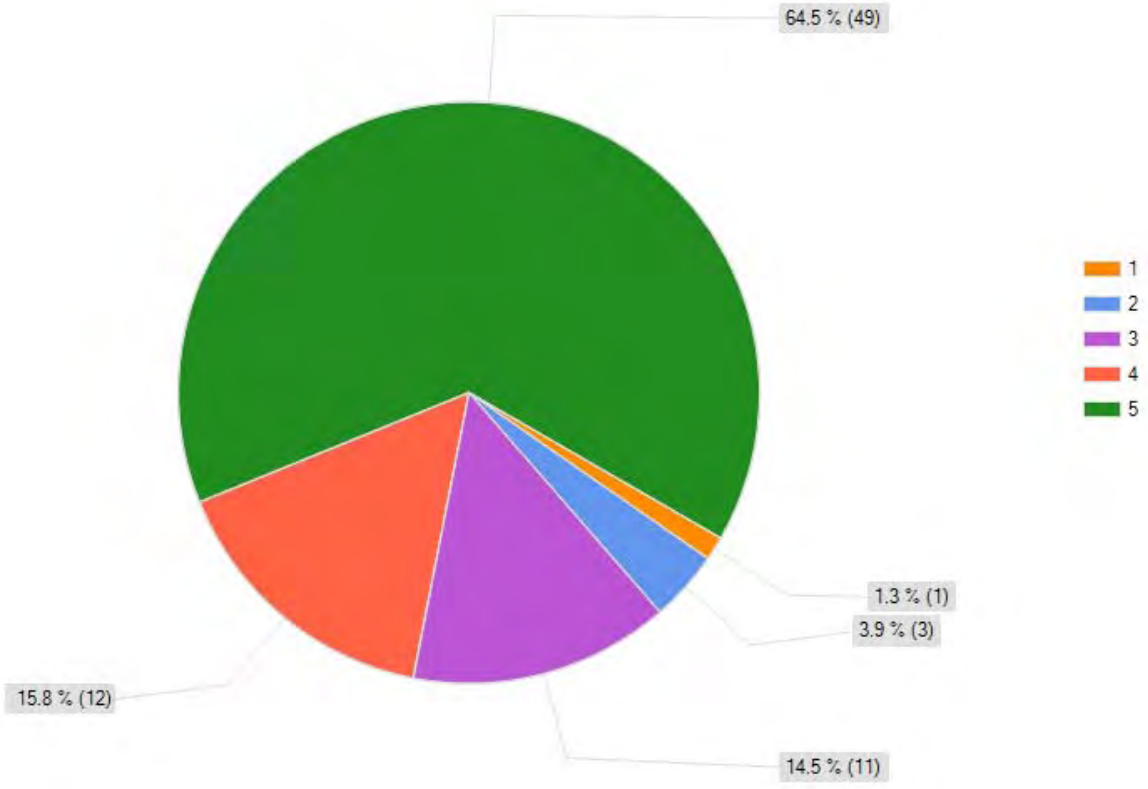
SurveyMonkey

4. How likely are you to use the FSLG website in the future? Not Likely = 1; Very Likely = 5

	Response Percent	Response Count
1	1.3%	1
2	3.9%	3
3	14.5%	11
4	15.8%	12
5	**64.5%**	**49**
	Comments	7
	answered question	**76**
	skipped question	**4**

	Comments	
1	I couldn't do my job without the FSLG Web site.	Dec 2, 2010 5:28 PM
2	I use it every day and will do so in the future.	Dec 3, 2010 12:09 PM
3	Don't know.	Jan 4, 2011 9:52 AM
4	I consider the website to be critical in the effort to keep the City in compliance with tax exempt and taxable bond rules and requirements.	Jan 4, 2011 10:18 AM
5	Use it but not often due to the difficulty of finding things. Often easier to access through other sources.	Jan 12, 2011 2:38 PM
6	I use it for forms, tax table reference, and HSA eligible expenses.	Jan 12, 2011 2:50 PM
7	Right now I mostly use the regular IRS website, I was not even aware there was a seperate tab for Government. I did go in and look and it to see what was out there that might help me, I was very disappointed at the lack of information that would help a payroll practitioner.	Jan 12, 2011 4:45 PM

4. **How likely are you to use the FSLG website in the future?Not Likely = 1; Very Likely = 5**



Questionnaire Regarding the Federal-State-Local Governments Website

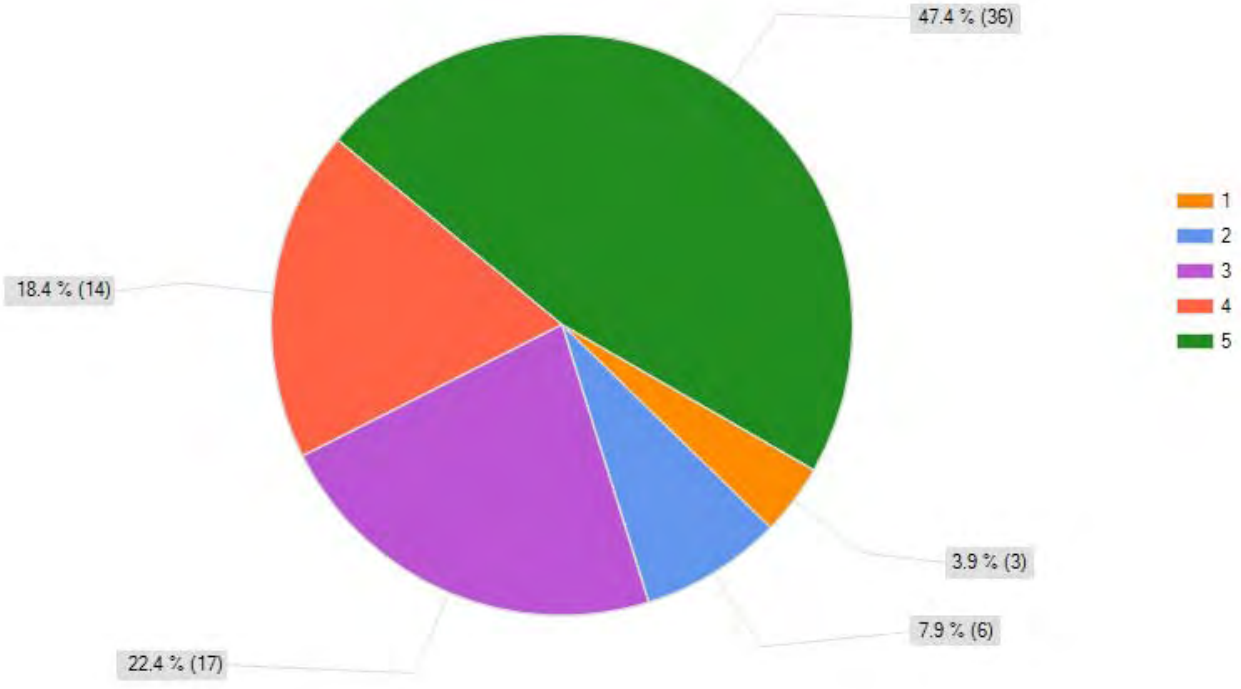
SurveyMonkey

5. How likely are you to recommend the FSLG website to someone else? Not Likely = 1; Very Likely = 5

	Response Percent	Response Count
1	3.9%	3
2	7.9%	6
3	22.4%	17
4	18.4%	14
5	**47.4%**	**36**
	Comments	7
	answered question	**76**
	skipped question	**4**

	Comments	
1	I refer employers to the site especially if the person I am dealing with is a new hire.	Dec 1, 2010 4:00 PM
2	We refer people to it all the time.	Dec 1, 2010 4:45 PM
3	I recommend the website as a reference for all State and local agencies in my state.	Dec 3, 2010 12:09 PM
4	Even though it's possibly not the best organized site, it's still the only game in town for official information.	Dec 16, 2010 10:43 AM
5	I have not used it.	Jan 4, 2011 9:52 AM
6	I would recommend to someone due to the necessity of understanding the IRC and upcoming changes. However, I do believe it can be more user friendly to layman and lower level staff.	Jan 4, 2011 10:56 AM
7	Simply wouldn't come to mind	Jan 12, 2011 2:29 PM

5. **How likely are you to recommend the FSLG website to someone else?Not Likely = 1; Very Likely = 5**



Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

6. Please indicate which area(s) of the website are most beneficial to you.

	Response Count
	37
answered question	**37**
skipped question	**43**

6. Please indicate which area(s) of the website are most beneficial to you.

	Response Text	
1	Virtually all of the information on the website has been helpful to me	Dec 1, 2010 2:23 PM
2	Fact sheets, and I refer to the site for explanations and updates.	Dec 1, 2010 4:00 PM
3	Publications, past articles, all of it.	Dec 1, 2010 4:45 PM
4	All are beneficial; unable to list specific area(s) - it depends on what information is needed when I enter the site.	Dec 2, 2010 5:28 PM
5	FSLG Newsletter FSLG Factsheet FSLG FAQ's	Dec 3, 2010 10:29 AM
6	FSLG Fact Sheets that answer specific questions for employers and provide a fast way to explain to an employee why they are and will not pay Social Security and or Medicare taxes. An example is when an employee calls about a rehired annuitant. I refer them to the Pub. 963 and the rehired annuitant factsheet. If the employee is wanting Social Security deducted and they are a rehired annuitant who is not covered under Section 218 then the Rehired Annuitant factsheet is a wonderful reference for both the employee and employer.	Dec 3, 2010 12:09 PM
7	All	Dec 8, 2010 1:36 PM
8	Employer's Toolkit	Dec 13, 2010 12:18 PM
9	it is nice to have information related to taxes of the government i.e, more information on a cafeteria plan, taxes, etc.	Dec 15, 2010 2:38 PM
10	FAQ Fact Sheets & Publications	Dec 15, 2010 3:33 PM
11	I very much appreciate the FLSG Fact Sheets. It's sometimes difficult to read IRS regulations which are primarily written for business, and figure out how to apply them to local government.	Dec 15, 2010 5:39 PM
12	I have not used it.	Jan 4, 2011 9:52 AM

6. Please indicate which area(s) of the website are most beneficial to you.

	Response Text	
13	See above. Tax exempt bond updates and guidance as well as taxable bond information on BAB's.	Jan 4, 2011 10:18 AM
14	Toolkit FAQs Newsletter Educ Products	Jan 4, 2011 10:56 AM
15	Forms and publications information	Jan 12, 2011 2:11 PM
16	tax tables, forms and publications are what I use the most.	Jan 12, 2011 2:18 PM
17	Specifically businees resources	Jan 12, 2011 2:19 PM
18	Fact Sheets	Jan 12, 2011 2:25 PM
19	Legislation updates	Jan 12, 2011 2:26 PM
20	Public Employer's tool kit.	Jan 12, 2011 2:29 PM
21	Newsletters and updates	Jan 12, 2011 2:45 PM
22	I use it for forms, tax table reference, and HSA eligible expenses.	Jan 12, 2011 2:50 PM
23	Information on new developments that affect federal state and local governments, especially the quick guides that provide a summary of how legislative/IRS action will affect local government operations, payroll and/or reporting.	Jan 12, 2011 3:01 PM
24	section 218, retirement plan	Jan 12, 2011 3:39 PM
25	New Letters / News room	Jan 12, 2011 3:54 PM
26	Summaries and updates	Jan 12, 2011 4:10 PM
27	The fact sheets, FAQs, and the toolkit are very helpful.	Jan 12, 2011 5:34 PM
28	news letter, forms and publication, FSLG fact sheet, educational products,	Jan 12, 2011 6:01 PM
29	Up to this point, I've mostly used the Forms & Publications and Newsroom sections through the Businesses tab. However, in future I will start in the Government Entities tab - FSLG section & at least scan the link headings for new or updated postings.	Jan 13, 2011 12:42 PM
30	Front page	Jan 13, 2011 1:48 PM
31	EDUCATIONAL PRODUCTS & THE FLSG FACT SHEETS	Jan 13, 2011 2:30 PM
32	All FSLG sites.	Jan 14, 2011 6:26 PM
33	The updates to tax situations and legislation, FAQ, and Factsheets	Jan 18, 2011 7:28 PM
34	Updates	Jan 20, 2011 1:41 PM
35	forms/publications (particularly those with "fill-in", save and print options) benefit taxation information (needed "on demand" when my employer is negotiating changes or new benefits taxation and reporting for deceased employees and their estate (little used information so I would be looking procedures up each time) "What's new" information	Jan 28, 2011 5:35 PM
36	forms and instructions ordering forms code updates webinar postings	Feb 7, 2011 11:10 AM
37	ALL	Feb 11, 2011 1:25 PM

Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Count
	24
answered question	**24**
skipped question	**56**

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Text	
1	More FAQs with greater detail.	Dec 2, 2010 5:28 PM
2	More links to the Publication 963 should be placed on the different pages off the website. I found the link to Pub 963 on the Educational Products and Toolkit. It should also be on the main page. I would also like the names and phone number of the local FSLG agents listed on the wesite.	Dec 3, 2010 12:09 PM
3	Update Pub 963 to be more understandable and complete.	Dec 13, 2010 12:18 PM

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Text	
4	Charts by State - based on Section 218 agreements Sheets that can be given to employees (teachers, retirees, elected board members) about how they are subject to social security medicare etc. There is the Rehired Annuitants page but you can't really give it to the employee for them to understand. More FAQ More if then - If employee is a ... then ....; if benefit is then taxable or not taxable More on strange cases - like a Retired Teacher is now a Board Member how should they be coded for Social Security; or when employees receive different types of payments or benefits what is taxable for each of the items (Federal Taxable, Federal Income tax withheld, Social Security, Medicare) Publication like the State of CA benefit taxable chart but better; http://www.edd.ca.gov/pdf_pub_ctr/de231eb.pdf Can a employee be a employee and independent contractor for the same employer section; what happens if you have a independent contractor then hire them as a employee that same year in a different position. Reporting Requirements for SSA & IRS for W-2/941 based on public schools different ways they are set up and run and different reporting requirements then a private company. i.e schools do not pay social security for teachers that are members of STRS, schools have different groups of employee (certificated and classifed) Keep up the good work assisting public schools	Dec 15, 2010 3:33 PM
5	Fact sheets on more topics. Self-service training classes (with CPE) like the State of Colorado Department of Revenue does. Maybe a "question of the month" with an answer.	Dec 15, 2010 5:39 PM
6	There should be useful headings, such as "training," "employment tax," "1099 Reporting," etc. The most frequently used items by government entities should be represented. It might be helpful to have sections specifically for state, local, and tribal governments. That way, we'll know which items are applicable to our situation.	Dec 16, 2010 10:43 AM
7	I have not used it.	Jan 4, 2011 9:52 AM
8	General organization - it would be nice to have better topics, for example Research, Newsroom, etc. Instead there is the general throw everything at you that you have to weed through to get what you want. I would really like to see a dedicated newsroom, keeping me appraised of what potential changes are coming and the status of certain rulings, etc.	Jan 4, 2011 10:56 AM
9	Forms and publications, and other information related only to Public employers	Jan 12, 2011 2:11 PM
10	The website is very good and leads you to links of interest.The search engne is most beneficial to me. The site offers many options for searching on a topic.I find it easy and informative.	Jan 12, 2011 2:19 PM

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Text	
11	It would be easier to find info if it was sorted by catagories, then list the detail links example - Employees then Elected, Appointed, Public Safety, Exempt, Nonexempt, Home Based, Election works, volunteers etc. Benefits then Employer paid or Employee paid	Jan 12, 2011 2:25 PM
12	Improve ability to search and find subjects, make it easier to pick out and see topics you may be looking for. Also, unless one goes looking at it regularly, it's hard to know when something has been updated or added.	Jan 12, 2011 2:29 PM
13	It could carry state information	Jan 12, 2011 2:45 PM
14	Easy links to publications such as the Taxable Fringe Benefits Guide for Federal, State and Local Governments.	Jan 12, 2011 3:01 PM
15	It would be helpful to have subject areas that are specific to government/education such as 403/457; taxable issues for benefits, retirement, etc. Trying to decipher what to do about faculty salaries that were spread over a calendar year versus an academic year and whether or not we should be taxing was a nightmare. Obama's healthcare changes affect government/education different...give us some help trying to understand what you want from us. Don't make it a tracking nightmare that our system does not have the capability to track for us.	Jan 12, 2011 4:45 PM
16	Searching for specific Internal Revenue Bulletins is difficult. It would be helpful for them to be indexed by date and topic/content.	Jan 12, 2011 5:34 PM
17	Since I plan to scan the link headings section of the FSLG page, it would be most helpful if the links were flagged with the posting dates & grouping them by similar subject matter would also be helpful.	Jan 13, 2011 12:42 PM
18	Keep it updated. It is important to be able to find updates quickly. Did the Make work pay tax credit expire? Did the employer credit for SS from the Hire Act get extended? These are just two examples of information I need that would be in recent legislation.	Jan 13, 2011 1:48 PM
19	Finding a subject seems to take many tries. It is understandable considering the amount of information that is included in the site. A simple alpha index might be useful.	Jan 14, 2011 6:26 PM
20	Need more detailed information/topics in a timely manner. Could use more questions for the "frequently asked question and answer" section with specific examples.	Jan 18, 2011 1:27 PM
21	Hard to find Forms as they are under the heading "Public Employees Tool Kit". Tool Kit doesn't give a good clue to that is where the forms are.	Jan 18, 2011 7:28 PM
22	"search" capability within the FSLG area clear examples so, hopefully, I will not feel it so necessary to call and talk to someone The list of subjects appears random on the FSLG home page Easier way to refer employees to tax calculation tools	Jan 28, 2011 5:35 PM

7. Please indicate which area(s) of the website should be improved and how such improvements would benefit you as a public employer.

	Response Text	
23	a place where we could post a question (s) and have them sent directly to an IRS agent a list of phone numbers where we could contact the correct person at the IRS directly (for instance: I have been doing 1099 forms for several years and I just recently found this phone number which has been very helpful, 1-866-455-7438.)	Feb 7, 2011 11:10 AM
24	Provide more information.	Feb 7, 2011 2:48 PM

Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

8. Please provide any general comments.

	Response Count
	16
answered question	**16**
skipped question	**64**

8. Please provide any general comments.

	Response Text	
1	Keep it going....	Dec 1, 2010 4:45 PM
2	Website provides useful information for government entities.	Dec 3, 2010 10:29 AM
3	The IRS should notify State Administrators when the update the Pub. 963 or FSLG Website. The Q&A's should behind each chapter of the Pub. 963 and not in a separate chapter. State and local empoyers also need to know who the FLSG agents are in their state and have contact information.	Dec 3, 2010 12:09 PM
4	Spell check on these screens for the fill in boxes.	Dec 15, 2010 3:33 PM
5	We are a public school district and there needs to be a specific site for public schools, Kindergarten through High School. We differ greatly from Colleges and Universitites. I have ask the American Payroll Association to have a conference for public education K-12 as well. We have very few resources to easily and reliably go to for information. Babs Rickert Linn Benton Lincoln ESD Alabny, OR 541-812-2642	Jan 12, 2011 2:19 PM
6	The newsletter isn't all that great. Spiff it up a bit, make it more appealing to read.	Jan 12, 2011 2:29 PM
7	Organize it in such as way that subject matter can be quickly and easily accessed.	Jan 12, 2011 2:38 PM
8	It really is a helpful tool.	Jan 12, 2011 2:45 PM
9	Didn't know it existed. Will follow up and take a look at it.	Jan 12, 2011 3:27 PM

8. Please provide any general comments.

	Response Text	
10	As a payroll professional, we want to follow ALL the rules, but sometimes it is almost impossible for us to know what the IRS wants from us...any help you can provide would be very welcome! :) Don't just change the rules...give us time to react and get our systems set up to track the information you want from us. Most of all, thanks for asking for our opinion, it shows us that you are willing to make things better.	Jan 12, 2011 4:45 PM
11	The website is a great resource. I use it all of the time. The volume of information is great; but can be problematic when sifting through it for what you really need/want.	Jan 12, 2011 5:34 PM
12	I'll be bookmarking this/adding to 'My Favorites,' thank you!	Jan 12, 2011 7:06 PM
13	I'm very glad I took this survey, since it now know about the FSLG section which is more beneficial to my job since I work for a state political subdivision. Thanks!	Jan 13, 2011 12:42 PM
14	I don't really use it because it hasn't been helpful to me in past instances. Maybe there have been changes in the last year or so that have been an improvement. I plan to take a look again.	Jan 15, 2011 9:18 PM
15	Would be nice to be able to contact staff by e-mail as many times if they do not answer when you call, you have to take the time to call back. With an e-mail they can reply when they have a chance.	Jan 18, 2011 7:28 PM
16	I appreciate the effort to help us get and keep compliant. The few Webinars I've watched have been helpful. The Section 218 was particularly helpful because there was an easily-to-find link to the actual transcript read during the presentation. The information is covered far too fast to take notes so the transcript is great. Being able to reaccess the information via video is great.	Jan 28, 2011 5:35 PM

Questionnaire Regarding the Federal-State-Local Governments Website

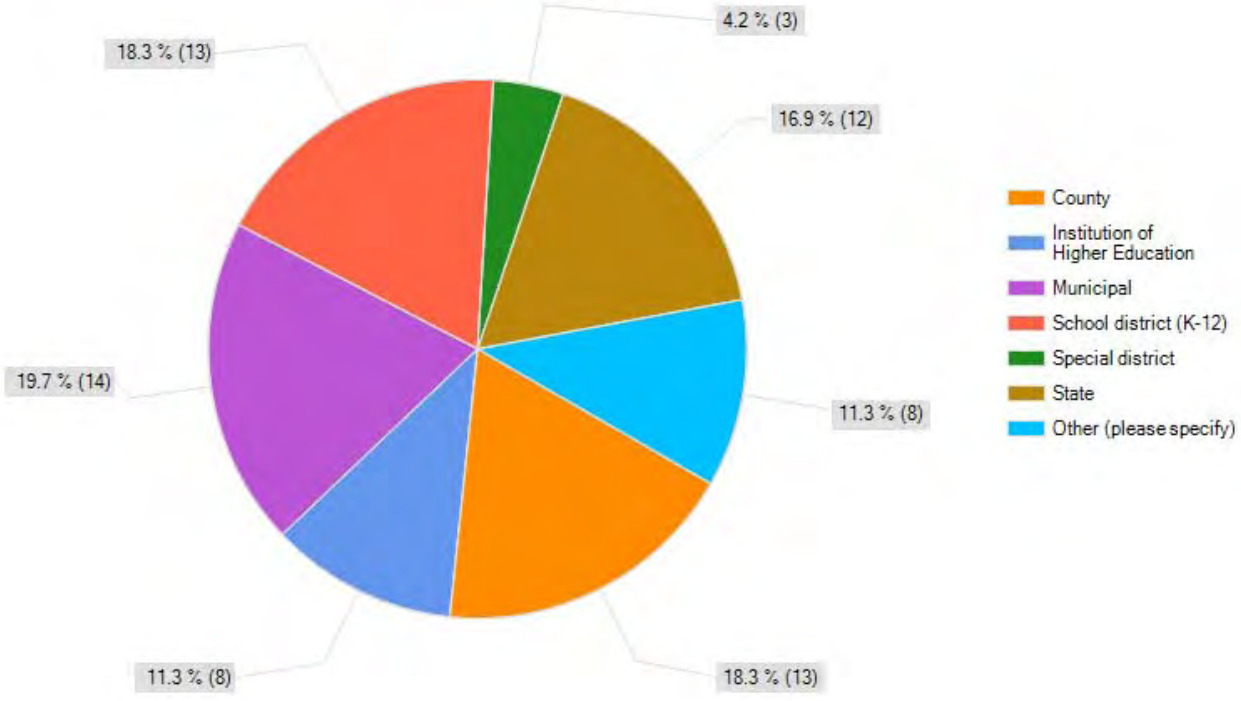
SurveyMonkey

9. Type of Government

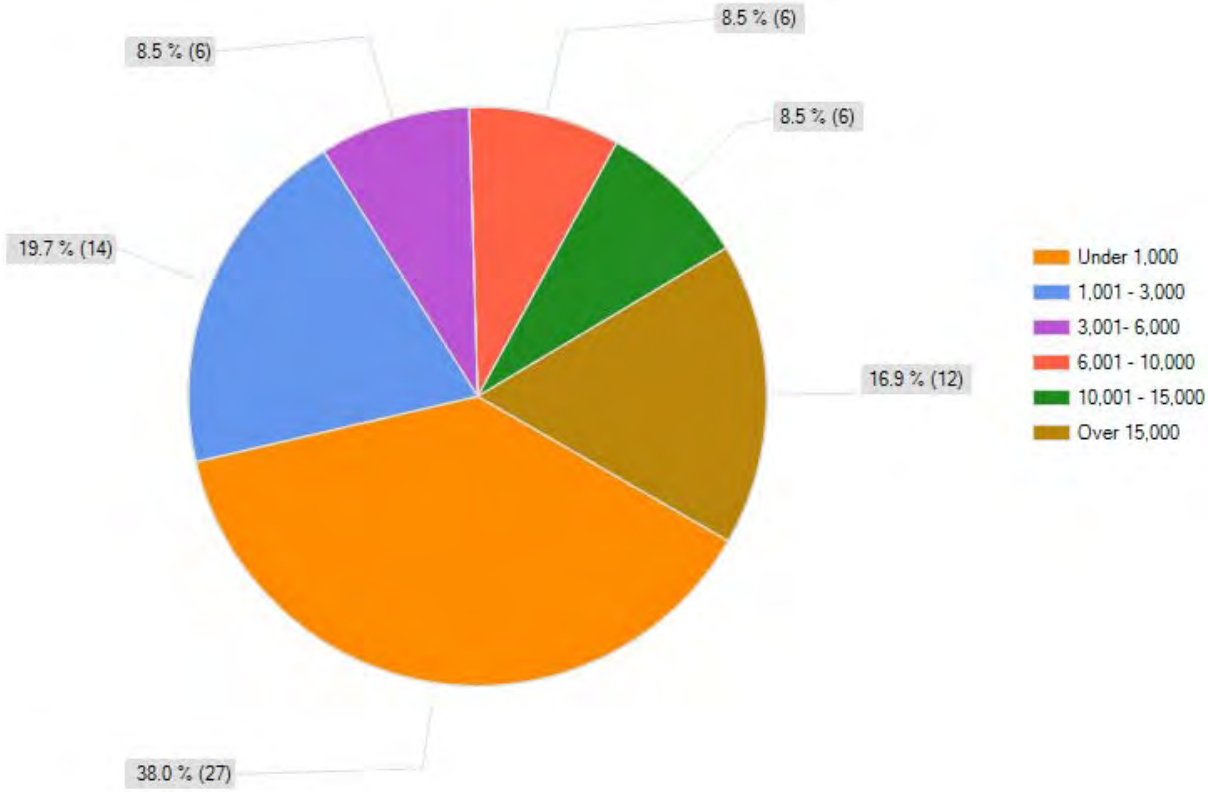
	Response Percent	Response Count
County	18.3%	13
Institution of Higher Education	11.3%	8
Municipal	**19.7%**	**14**
School district (K-12)	18.3%	13
Special district	4.2%	3
State	16.9%	12
Other (please specify)	11.3%	8
	answered question	**71**
	skipped question	**9**

	Other (please specify)	
	State Social Security Administrator for Alaska	Dec 1, 2010 4:49 PM
2	Defense contractor	Jan 12, 2011 3:42 PM
	nonprofit	Jan 12, 2011 3:54 PM
4	non-profit research & analysis	Jan 12, 2011 7:09 PM
	Political Subdivision of the State of Texas - specifically a River Authority	Jan 13, 2011 12:44 PM
6	Authority-Political Subdivision	Jan 13, 2011 4:12 PM
	County Office of Education - K-12 and Higher Education	Jan 18, 2011 7:30 PM
	City	Jan 20, 2011 12:38 PM

9 Type of Government



10 **Please indicate the approximate number of employees according to the following categories:**



Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

11. Title of Person who completed this questionnaire.

	Response Count
	69
answered question	**69**
skipped question	**11**

11. Title of Person who completed this questionnaire.

	Response Text	
1	Accounting Division Manager	Dec 1, 2010 2:24 PM
	Assistant Director	Dec 1, 2010 3:15 PM
3	Internal Legal Counsel/Policy Analyst	Dec 1, 2010 4:02 PM
	Alaska State Social Security Administrator	Dec 1, 2010 4:49 PM
5	State Social Security Coordiantor	Dec 2, 2010 5:28 PM
	State Social Security Analyst	Dec 3, 2010 10:32 AM
7	State Social Security Administrator	Dec 3, 2010 12:11 PM
	State Social Security Administrator	Dec 8, 2010 12:59 PM
9	Director of Accounting	Dec 8, 2010 1:38 PM
	Assistant Director	Dec 13, 2010 12:19 PM
11	Finance Director	Dec 15, 2010 2:38 PM
	Payroll Clerk	Dec 15, 2010 3:15 PM
13	Payroll Supervisor	Dec 15, 2010 3:34 PM
	Professional Accounting Specialist - 3% withholding	Dec 15, 2010 5:29 PM
15	Finance Director	Dec 15, 2010 5:40 PM
	Financial Administrator	Dec 16, 2010 10:44 AM
17	Finance Clerk	Jan 4, 2011 9:52 AM
	Director of Finance	Jan 4, 2011 10:18 AM
19	Director of Finance	Jan 4, 2011 10:38 AM
	Accounting Manager	Jan 4, 2011 10:57 AM
21	Accounting Manager	Jan 4, 2011 12:14 PM
	Accounting Operations Manager	Jan 4, 2011 1:54 PM
23	director of finance	Jan 5, 2011 9:37 AM
24	Assistant to the County Administrator	Jan 11, 2011 11:31 AM

11. Title of Person who completed this questionnaire.

	Response Text	
25	Payroll Coordinator	Jan 12, 2011 2:14 PM
26	Account Clerk III/Payroll	Jan 12, 2011 2:14 PM
27	Payroll Admin	Jan 12, 2011 2:14 PM
28	Payroll Manager	Jan 12, 2011 2:19 PM
29	Payroll Specialist	Jan 12, 2011 2:20 PM
30	Payroll Supervisor	Jan 12, 2011 2:20 PM
31	finance tech	Jan 12, 2011 2:23 PM
32	Payroll/Benefits Coordinator	Jan 12, 2011 2:26 PM
33	Payroll Manager	Jan 12, 2011 2:29 PM
34	Payroll Manager	Jan 12, 2011 2:30 PM
35	Manager - Payroll	Jan 12, 2011 2:38 PM
36	Payroll/Benefits Coordinator	Jan 12, 2011 2:50 PM
37	Payroll Analyst/SAP Configuration	Jan 12, 2011 2:57 PM
38	Payroll Financial Analyst/Auditor	Jan 12, 2011 3:01 PM
39	Payroll Manager	Jan 12, 2011 3:28 PM
40	Payroll Manager	Jan 12, 2011 3:40 PM
41	Manager of Payroll and A/P	Jan 12, 2011 3:42 PM
42	Payroll Manager	Jan 12, 2011 3:49 PM
43	Dir Education and Training	Jan 12, 2011 3:54 PM
44	Payroll Manager	Jan 12, 2011 3:56 PM
45	Accounting Managers	Jan 12, 2011 4:10 PM
46	Payroll Specialist	Jan 12, 2011 4:46 PM
47	Sr Account Clerk	Jan 12, 2011 4:51 PM
48	Payroll Director	Jan 12, 2011 5:35 PM
49	Payroll and Benefits Accountant	Jan 12, 2011 6:02 PM
50	Lead Payroll Specialist	Jan 12, 2011 7:09 PM
51	Payroll Supervisor	Jan 13, 2011 9:55 AM
52	Payroll Manager	Jan 13, 2011 11:21 AM
53	Accounting Assistant II	Jan 13, 2011 12:44 PM
54	Payroll Supervisor	Jan 13, 2011 1:49 PM
55	PAYROLL COORDINATOR	Jan 13, 2011 2:32 PM
56	Manager of Accounting	Jan 13, 2011 4:12 PM
57	Finance Director	Jan 14, 2011 4:57 PM
58	Social Security Administrator Staff	Jan 14, 2011 6:26 PM
59	Payroll Manager	Jan 15, 2011 9:19 PM
60	Staff Auditor	Jan 18, 2011 1:28 PM
61	Director of Support Services	Jan 18, 2011 7:30 PM
62	PAYROLL TECHNICIAN	Jan 19, 2011 9:10 PM
63	Payroll Specialist	Jan 20, 2011 12:38 PM
64	Payroll Supervisor	Jan 28, 2011 5:40 PM
65	Accounts Payable Supervisor	Feb 7, 2011 11:11 AM

11. Title of Person who completed this questionnaire.

	Response Text	
66	Senior Accounting Supervisor	Feb 7, 2011 2:50 PM
67	Internal auditor; formerly Mgr of Accounting Svcs	Feb 11, 2011 10:56 AM
68	PAYROLL SUPERVISOR/PAYROLL ACCOUNTANT	Feb 11, 2011 1:27 PM
69	Payroll Director	Feb 15, 2011 2:50 PM

Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

12. **Years of experience in this position (please specify).**

	Response Count
	70
answered question	**70**
skipped question	**10**

12. **Years of experience in this position (please specify).**

	Response Text	
1	25	Dec 1, 2010 2:24 PM
2	20	Dec 1, 2010 3:15 PM
3	4	Dec 1, 2010 4:02 PM
4	20 years	Dec 1, 2010 4:49 PM
5	4	Dec 2, 2010 5:28 PM
6	Three	Dec 3, 2010 10:32 AM
7	39	Dec 3, 2010 12:11 PM
8	5	Dec 8, 2010 12:59 PM
9	3 yrs	Dec 8, 2010 1:38 PM
10	Four	Dec 13, 2010 12:19 PM
11	5 yrs	Dec 15, 2010 2:38 PM
12	12	Dec 15, 2010 3:15 PM
13	2	Dec 15, 2010 3:34 PM
14	1	Dec 15, 2010 5:29 PM
15	25	Dec 15, 2010 5:40 PM
16	8	Dec 16, 2010 10:44 AM
17	8 years	Jan 4, 2011 9:52 AM
18	12 years	Jan 4, 2011 10:18 AM
19	1	Jan 4, 2011 10:38 AM
20	Private - 6 years Public - 3 years	Jan 4, 2011 10:57 AM
21	3	Jan 4, 2011 12:14 PM
22	4	Jan 4, 2011 1:54 PM
23	23	Jan 5, 2011 9:37 AM
24	12	Jan 11, 2011 11:31 AM

12. Years of experience in this position (please specify).

	Response Text	
25	2 years	Jan 12, 2011 2:14 PM
26	10.5	Jan 12, 2011 2:14 PM
27	11	Jan 12, 2011 2:14 PM
28	20+	Jan 12, 2011 2:19 PM
29	14 years	Jan 12, 2011 2:20 PM
30	26 years	Jan 12, 2011 2:20 PM
31	22	Jan 12, 2011 2:23 PM
32	12	Jan 12, 2011 2:26 PM
33	1	Jan 12, 2011 2:29 PM
34	22	Jan 12, 2011 2:30 PM
35	5	Jan 12, 2011 2:38 PM
36	Benefits and Compensation Administrator	Jan 12, 2011 2:47 PM
37	13	Jan 12, 2011 2:50 PM
38	6	Jan 12, 2011 2:57 PM
39	3	Jan 12, 2011 3:01 PM
40	32	Jan 12, 2011 3:28 PM
41	26	Jan 12, 2011 3:40 PM
42	+ 20 years	Jan 12, 2011 3:42 PM
43	20+	Jan 12, 2011 3:49 PM
44	17	Jan 12, 2011 3:54 PM
45	12	Jan 12, 2011 3:56 PM
46	4 at the School District	Jan 12, 2011 4:10 PM
47	5 years in Payroll Education 25+ in Payroll	Jan 12, 2011 4:46 PM
48	25 yrs	Jan 12, 2011 4:51 PM
49	4	Jan 12, 2011 5:35 PM
50	5	Jan 12, 2011 6:02 PM
51	12	Jan 12, 2011 7:09 PM
52	3	Jan 13, 2011 9:55 AM
53	17 years	Jan 13, 2011 11:21 AM
54	23 years & counting	Jan 13, 2011 12:44 PM
55	30	Jan 13, 2011 1:49 PM
56	OVER 25 YEARS	Jan 13, 2011 2:32 PM
57	5	Jan 13, 2011 4:12 PM
58	25	Jan 14, 2011 4:57 PM
59	3 years	Jan 14, 2011 6:26 PM
60	4 years	Jan 15, 2011 9:19 PM
61	10+	Jan 18, 2011 1:28 PM
62	18 years	Jan 18, 2011 7:30 PM
63	14 YEARS	Jan 19, 2011 9:10 PM
64	16	Jan 20, 2011 12:38 PM

12. Years of experience in this position (please specify).

	Response Text	
65	29	Jan 28, 2011 5:40 PM
66	3	Feb 7, 2011 11:11 AM
67	6 years	Feb 7, 2011 2:50 PM
68	10	Feb 11, 2011 10:56 AM
69	20+	Feb 11, 2011 1:27 PM
70	25	Feb 15, 2011 2:50 PM

Questionnaire Regarding the Federal-State-Local Governments Website

SurveyMonkey

13. **Optional: Name and contact information of person completing the questionnaire.**

	Response Percent	Response Count
Name:	88.6%	31
Company:	88.6%	31
Address:	77.1%	27
Address 2:	11.4%	4
City/Town:	82.9%	29
State:	**94.3%**	**33**
ZIP:	82.9%	29
Country:	74.3%	26
Email Address:	85.7%	30
Phone Number:	77.1%	27
	answered question	**35**
	skipped question	**45**

Appendix B:

Website Posting of Questionnaire Regarding the Federal, State and Local Governments Website

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To: Federal, State and Local Governmental Employers ("Public Employers")

From: Internal Revenue Service, Advisory Committee on Tax Exempt and Government Entities, Federal-State-Local Government (FSLG) Subcommittee

RE: Questionnaire Regarding the Federal-State-Local Governments (Government Entities) Website: http://www.irs.gov/govt/fslg/index.html

Date: December 1, 2010

Federal, state, and local government ("public") employers are subject to employment taxes (Social Security, Medicare, public pension systems, and fringe benefits) and regulations which are different from those for private sector employers. Ten years ago, the U.S. Treasury Department and the Internal Revenue Service (IRS), Tax Exempt and Government Entities (TE/GE) Division, created an Advisory Committee that was established to provide customer input on various tax matters affecting federal, state, and local governments, including matters pertaining to public institutions of higher education. As a subunit of the ACT, the Federal-State-Local Governments (FSLG) Committee has created a questionnaire to see if the current IRS/FSLG website (located at http://www.irs.gov/govt/fslg/index.html) contains the appropriate, needed information for federal, state and local governments and also to determine what, if any, improvements to the website should be recommended to the IRS.

We encourage and welcome you to respond to the questionnaire which can be accessed via the NCSSSA website at http://www.ncsssa.org/whatsnewcombo.html. Your responses, when aggregated with others, will provide our committee with feedback to give to the IRS/FSLG Office, so they can make appropriate and useful changes to their website. The responses to this questionnaire will be held completely confidential by the ACT Committee members and will be used solely for the purpose of identifying areas for improvement to the IRS/FSLG website. No individual identifying information will be shared with the IRS or anyone else.

The ACT will receive comments on this Questionnaire until March 1, 2011. To access the questionnaire, please go to http://www.ncsssa.org/whatsnewcombo.html. ***Completion of the questionnaire itself should only take a few moments of your time.***

If there are any questions, you may send an email to Maryann Motza, FSLG Website Project Leader: maryann.motza@state.co.us.

Thank you, in advance, for your assistance in refining and improving this valuable information source for federal, state and local governments.

Sincerely,

Maryann Motza
Paul Carlson
Patricia Phillips
IRS/Advisory Committee on Tax Exempt and Government Employment (TE/GE) (ACT)
Federal-State-Local Government (FSLG) Subcommittee Members (2010-2011)

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Appendix C:

Article in the IRS/FSLG Newsletter Related to the Questionnaire Regarding the Federal, State and Local Governments Website

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Internal Revenue Service
Office of Federal, State and Local Governments

www.irs.gov/govt

FSLG Newsletter – January 2011

This is the semiannual newsletter of the office of Federal, State and Local Governments (FSLG) of the Internal Revenue Service. Our mission is to ensure compliance by Federal, state, and local governmental entities with Federal employment and other tax laws through review as well as educational programs.

For more information, visit our web site at www.irs.gov/govt. For account-related assistance, contact Customer Account Services at 1-877-829-5500. To identify a local FSLG Specialist, see the directory at the end of this newsletter.

The explanations and examples in this publication reflect the interpretation by the IRS of tax laws, regulations, and court decisions. The articles are intended for general guidance only, and are not intended to provide a specific legal determination with respect to a particular set of circumstances. You may contact the IRS for additional information. You may also want to consult a tax advisor to address your situation.

Federal, State and Local Governments

Paul Marmolejo, Director
Phyllis Burnside, Manager, Compliance and Program Management (CPM)
Stewart Rouleau, Newsletter Editor (send comments to Stewart.G.Rouleau@irs.gov)

Contents

REGULATIONS ELIMINATE PAPER DEPOSIT COUPONS

On August 19, 2010, IRS News Release 2010-92 announced proposed regulations (REG 153340-09) that would require all Federal tax deposits to be made using the Electronic Federal Tax Payment System (EFTPS) beginning January 1, 2011. On December 7, 2010, the IRS published Treasury Decision 9507, making these regulations final. The new regulations relate to all tax types that have been paid with Form 8109, Federal Tax Deposit Coupon:

- Form 720, Quarterly Federal Excise Tax Return
- Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return (includes Form 940-PR)
- Form 941, Employer's QUARTERLY Federal Tax Return (includes Forms 941-M, 941-PR, and 941-SS)
- Form 943, Employer's Annual Federal Tax Return for Agricultural Employees
- Form 944, Employer's ANNUAL Federal Tax Return (includes Forms 944-PR, 944(SP), and 944-SS)
- Form 945, Annual Return of Withheld Federal Income Tax
- Form 1120, U.S. Corporation Income Tax Return (includes Form 1120 series of returns and Form 2438)
- Form 990-T, Exempt Organization Business Income Tax Return
- Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation
- Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
- Form CT-1, Employer's Annual Railroad Retirement Tax Return

The Treasury Decision notes that the Treasury Department will no longer maintain the paper deposit coupon system after 2010. The regulations do not change existing rules for determining a depositor's status as either a monthly or semiweekly depositor for employment taxes. The regulations also do not change existing rules on whether a taxpayer can remit taxes with a return in lieu of making a deposit. For example, Form 941 filers with a deposit liability of less than $2,500 for a return may continue to submit payment with the return.

Depositing electronically offers many advantages over the paper coupon system. It allows deposits to be made at any time, from a computer or telephone, and to schedule deposits in advance. The system also greatly reduces the possibility of errors and eliminates the need to order and retain coupons. EFTPS is pre-enrolling all taxpayers that used a coupon in the past 18 months but do not have an active EFTPS enrollment. To get up to date information or to enroll in EFTPS, visit the EFTPS website at www.eftps,gov, or call 1-800-555-4477.

For more information, see the final regulations.

HELP IMPROVE THE FSLG WEBSITE

BY MARYANN MOTZA, COLORADO SOCIAL SECURITY ADMINISTRATOR
MEMBER, ACT ADVISORY COMMITTEE

The Federal, State, and Local Governments (FSLG) office of the Tax Exempt and Government Entities (TE/GE) Division of the IRS has a website that provides tax Information pertinent to Federal, State, & Local Governments (located at http://www.irs.gov/govt/fslg/index.html).

The IRS Advisory Committee on Tax Exempt and Governmental Entities (ACT), FSLG Subcommittee, is reviewing the FSLG website to assess its usefulness and value to FSLG customers. To aid us in that process, we are asking public employers and their legal and financial advisors as well as public employees to complete a brief questionnaire related to the website. The National Conference of State Social Security Administrators (NCSSSA) has graciously agreed to serve as the host website for the ACT/FSLG Subcommittee's evaluation of the FSLG website.

The ACT/FSLG Subcommittee asks those who want to provide feedback to the IRS on its FSLG website to go to http://www.ncsssa.org/whatsnewcombo.html and click on the "FSLG Website Questionnaire" link, which will take you to the survey tool we are using to compile the data. Please complete the questionnaire ***on or before March 1, 2011***. We know that your time is valuable, so the questionnaire is structured to only take a few minutes to complete. There is no cost to you for completing the form on-line.

To ensure the feedback we receive is as complete and thorough as possible, we suggest that, prior to completing the questionnaire, you review information contained throughout the current FSLG website. If you do not have time to review the entire website, we suggest that you, at a minimum, review the links on the left side of the home (landing) page of the website (http://www.irs.gov/govt/fslg/index.html), which are labeled as follows:

Federal, State, and Local Government Topics

- About FSLG
- FSLG Newsletter
- FSLG Customer Services
- Educational Products
- FSLG Fact Sheets
- FSLG FAQs
- FSLG Toolkit
- FSLG Work Plan
- More Topics . .

IRS Resources

- Compliance & Enforcement
- Contact My Local Office
- e-file
- Forms and Publications
- Newsroom
- Frequently Asked Questions
- Taxpayer Advocate Service
- Where To File

We also ask you to comment on the search feature for the FSLG website (located in the upper right of each page).

We will consider all comments and suggested changes to the site, but cannot guarantee that all recommendations will be incorporated into the final report that will be provided to the IRS during the June 2011 public meeting. No individual responses received during the evaluation process will be documented or listed under the originator's name/entity name. All data will be recorded according to a number we will assign to all evaluations we receive. Only cumulative data will be reported in the June 2011 ACT Report, which will be available later that month the IRS website.

If you have questions or need further information about the website evaluation project, the ACT/FSLG Subcommittee's evaluation process, or other information pertinent to this project, please email Maryann Motza, Project Leader, at: maryann.motza@state.co.us.

Thank you in advance for your help.

Maryann Motza
Patti Phillips
Paul Carlson

ACT/FSLG Subcommittee Members

FOSTER CARE AND BIOLOGICAL PARENTS

BY WANDA VALENTINE, FSLG SENIOR ANALYST

State and local governments provide programs and services to enable disabled children and adults to avoid institutionalization and to remain at home and in the community. Questions have arisen whether certain payments to biological parents for the care of their own children may be excludable from gross income as “difficulty of care payments” under section 131 of the Internal Revenue Code.

Section 131

Section 131 provides that a foster care provider may exclude “qualified foster care payments” from gross income. A qualified foster care payment must be made pursuant to the foster care program of a state or political subdivision of a state. The payer must be a state, a political subdivision of a state, or a “qualified foster care placement agency.” A qualified foster care placement agency is a placement agency that is licensed or certified - by a state, a political subdivision of a state, or an entity designated by a state or a political subdivision of a state - for the foster care program of the state or the political subdivision of the state.

In addition to payments for basic foster care, qualified foster care payments may include “difficulty of care payments.” Difficulty of care payments are compensation for providing the additional care of a qualified foster individual that is required by reason of a physical, mental, or emotional handicap of the individual, if the care is provided in the foster care provider’s home and the state has determined a need for the additional compensation.

Section 131 does not define the term “foster care” or “foster care provider.” However, the ordinary meaning of foster care excludes care by a biological parent. To "foster" means to give parental care to a child who is not one's natural or legally adopted child. In addition, section 152(f)(1)(A)(i) and (ii) of the Code distinguish between a son or daughter and a foster child. Section 152(f)(1)(A)(i) defines the term “child” to mean an individual who is a son, daughter, stepson, or stepdaughter of the taxpayer or parent; whereas, section 152(f)(1)(A)(ii) defines the term “child” to include an eligible foster child of the taxpayer, which means an individual who is placed in the home of the taxpayer by an authorized placement agency, judgment or court order. IRS Chief Counsel published a Program Manager Technical Assistance (PMTA 2010-007) on March 29, 2010, concluding that a biological parent may not qualify as a foster care provider under section 131.

Example

County X makes payments to Parent Y, the biological mother of a disabled biological minor son, for providing 4 hours a day of nonmedical services. The payments provided to Parent Y cannot qualify as “difficulty of care payments” under section 131 of the Internal Revenue Code and are not excludable from gross income. Rather, these payments are compensation for services that are includible in the biological parent’s gross income.

CHANGES TO DRUG REIMBURSEMENTS UNDER FLEXIBLE SPENDING ARRANGEMENTS

BY STEWART ROULEAU, FSLG SENIOR ANALYST (WASHINGTON, DC)

Section 9003 of The Patient Protection and Affordable Care Act of 2010 adds section 106(f) to the Internal Revenue Code, imposing new restrictions on reimbursements for drug expenses from a health flexible spending arrangement (health FSA), or a health reimbursement arrangement (HRA).

A health FSA permits salary reduction by an employee to remain exempt from tax if used to reimburse medical expenses. The amounts placed in the FSA generally must be used within the same year they are contributed. An HRA is funded only by employer contributions and also excludes reimbursements from income if used to reimburse medical expenses. Amounts in an HRA may be carried over from year to year.

Under the new law, beginning with purchases made after December 31, 2010, only reimbursements for drugs that have been prescribed (regardless of whether they are available without a prescription) or insulin are excluded from income when paid under a health FSA or HRA. Thus, over-the-counter drugs purchased without a prescription (except for insulin) may not be reimbursed from a health FSA or HRA. The change does not affect other health care expenses, such as medical devices, eye glasses, contact lenses, co-pays and deductibles. The restriction applies even if funds were set aside in a health FSA or HRA before December 31, 2010.

Because health FSA or HRA debit cards cannot currently substantiate that over-the-counter drug expenses are prescribed, these cards may no longer be used to purchase over-the-counter drugs beginning January 1, 2011. However, the IRS will not challenge the use of these cards for over-the-counter drug expenses incurred through January 15, 2011, if the expenses otherwise comply with the debit card substantiation rules.

The same restrictions on over-the-counter drugs apply to a health savings account (HSA) or an Archer medical savings account (Archer MSA). These are accounts individuals set up with a trustee to pay for qualified medical expenses. Effective for distributions made after 2010, the new law also increases penalties from 15 to 20 percent for distributions from these accounts that are not used for medical expenses.

For more information on health FSAs or HRAs, or HSAs and Archer MSAs, see Publication 969 and the Cafeteria Plans Q&A on the FSLG website. See also Notice 2010-59 on the new rules for over-the-counter drugs.

ISSUES FOR NONRESIDENT ALIEN STUDENTS AND TEACHERS

BY ROBERT CHING, FSLG SPECIALIST (NEW MEXICO)

Many government-affiliated schools, colleges and universities employ students, teachers and scholars who do not have U.S. citizenship. The correct tax treatment of these individuals can depend on several considerations, including visa status, residency, sources of income and the length of stay. These entities need to be familiar with rules governing treatment of nonresident individuals. This article provides an introduction to the topic with direction to sources for further information.

The aim of this discussion is to provide some practical guidance in identifying the problems to be addressed when an educational institution employs a foreign worker. These foreign workers are often referred to as nonresident aliens. This article addresses only employees, **not** NRAs who are treated as independent contractors. For information on aliens performing independent personal services, see Publication 515.

Who is a Nonresident Alien?

Nonresident aliens (NRAs) are individuals who are NOT considered residents of the United States under §7701(b) of the Internal Revenue Code who are working for a U.S. employer. This Code section controls the determination of who is a resident alien and who is a nonresident alien for purposes of income taxation.

If it is determined that an individual is a resident alien, then he or she is subject to the same tax treatment applied to other resident individuals.

If the individual is determined to be an NRA, then you must consider both the Code provisions and applicable tax treaties. For information on specific tax treaties, see Publication 901, U.S. Tax Treaties.

What records should be kept if an individual is an NRA?

An institution must identify all foreign student and teachers who are not immigrating to the U.S. These foreign students and teachers have been admitted to the U.S. temporarily for the specific purpose of studying or training. All documentary evidence such as:

- Visas
- Copies of passports
- Form 8233, Exemption From Withholding on Compensation for Independent (and Certain Dependent) Personal Services of a Nonresident Alien Individual
- I-94, Arrival-Departure Record
- I-20 A-B/ID, Certificate of Eligibility for Nonimmigrant (F-1) Student Status)
- Communications with the US Citizenship and Immigration Services (USCIS), etc.

The IRS does not make determinations related to immigration or legal status, but addresses the classification of individuals as resident or nonresident aliens, and the correct application of the tax law based on that determination. If your institution has no NRA employees, you do not need to address the rules discussed in this article.

Employment and Student Visas

When you have identified the NRAs, you should determine whether any of the NRAs at the institution are receiving compensation as employees of your institution. For this purpose, compensation for employment may include cash payments, as well as compensation in the form of a scholarship, grant or tuition reduction.

A “qualified scholarship” is exempt from gross income under Internal Revenue Code section 117. In addition to establishing the purpose and use of the funds provided to the individual, you need to determine whether a portion of the amounts received represents payment for teaching, research or other services required of the recipient (see Regulation §1.117-6(d)). The exclusion from gross income under §117 does **not** apply to any portion attributable to services. Such amounts should be treated as wages; see Regulation §1.117-6(d)(4).

If the NRA has an F, J, Q or M visa, and is performing services **that carry out the purpose of the visa,** then the wages are **not** subject to social security or Medicare taxes (FICA). See §3121(b)(19). Notwithstanding the limitations of §3121(b)(19), an NRA student’s wages may be exempt from social security or Medicare taxes under the broader student worker exemption of §3121(b)(10).

However, if the NRA is a postdoctoral student/fellow, he or she may **not** be able to claim the student exemption from FICA for certain education-related services

provided under §3121(b)(10). See Revenue Procedure 2005-11 and the article "Medical Residents and FICA" in July 2010 FSLG Newsletter.

If the scholarship is not exempt under §117 and is **not** awarded in exchange for services**,** the payment may be reportable on Form 1042-S (see §871(c)) and could be subject to 14% or 30% withholding (see §1441(b)).

What steps should be taken, and when, for NRA employees?

In the case of NRA employees, the following should be considered:

- Students and teachers on a valid F, J, Q or M visa must apply for a social security number (Form SS-5) and **not** for an ITIN on Form W-7.
- Form W-4 should be completed with marital status "Single" and claiming one exemption (an exception applies for residents of Canada, Mexico, and Korea; see Publication 15). Nonresident Alien" should be written above Line 6 of W-4.
- In addition to regular income tax withholding, an amount applicable to NRAs must be added by the employer (see section 9 of Publication 15 and Notice 2009-91 for details).

However, if the NRA is a postdoctoral student/fellow, he or she may **not** be able to claim the student exemption from FICA for certain education-related services provided under §3121(b)(10). See Revenue Procedure 2005-11 and the article "Medical Residents and FICA" in July 2010 FSLG Newsletter.

These are some of the salient issues for NRA student and teacher employees. For more information refer to the following resources:

- Publication 15, Circular E (also Publication 15-A).
- Publication 515, Withholding of Tax on Nonresident Aliens
- Publication 901, US Tax Treaties.
- Rev. Proc. 88-24, Withholding at less than the statutory rate.
- Rev. Proc. 89-67, Scholarship or grant.

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	Hilton Finney	(215) 861-3732
Massachusetts	John Hart	(978) 474-9590
	Mary Rogers	(508) 559-4584
Michigan	Carolyn Beckwith	(810) 342-6148
	Lori Hill	(906) 228-7831
Minnesota	Steven Haupt	(651) 726-1488
	Pat Wesley	(218) 720-5305 225
Mississippi	John Givens	(251) 341-5993
Missouri	Sharon Boone	(417) 841-4535
	Dena Jones	(816) 966-2346
Montana	Dwiight Jacobs	(307) 672-7425 33
Nebraska	Thomas Goman	402) 233-7368
Nevada	Gary Petersen	(775) 325-9282
New Hampshire	John Hart	(978) 474-9590
New Jersey	Pat Regetz	(908) 301-2119
	Vincent Urciuoli	(908) 301-2660
New Mexico	Carl Chavez	(505) 837-5610
	Bob Ching	(509) 986-5260 224
	Toni Holcomb	(505) 527-6900 232
New York	Dave Coulon	(315) 233-7305
	Jean Redman	(607) 734-1063 108
	Fran Reina	(315) 793-2932
	Granville Shannon	(212) 719-6537
North Carolina	Jammie Owens	(336) 378-2961
North Dakota	Rhonda Kingsley	(701) 239-5400 261
Ohio	Trudee Billo	(419) 522-2359

	John Darr	(419) 526-2886
	Wendy Speelman	(419) 526-2607
Oklahoma	Brenda Hollingsworth	(405) 297-4959
Oregon	Lori Stieber	(503) 587-3149
Pennsylvania	Hilton Finney	(215) 861-3732
	Veronica Green Bell	(215) 861-1562
Puerto Rico	Fernando Echevarria	(954) 423-7406
Rhode Island	Mary Rogers	(508) 559-4584
South Carolina	Clifford Brown	(803) 253-3523
South Dakota	Rhonda Kingsley	(701) 239-5400 261
Tennessee	Wally Reimold	(615) 250-6051
Texas	Robert Jackson	(281) 721-7993
	Steve O'Brien	(512) 464-3129
	Michelle Pringle	(214) 413-5448
	Donna Richard	(512) 499-5033
	Sean Salas	(512) 464-3405
Utah	Chris Casteel	(208) 387-2829
US Virgin Islands	Clifford Brown	(803) 253-3523
Vermont	Fran Reina	(315) 793-2932
	Stephen Polak	(802) 859-1049
Virginia	Christina Chang	(703) 462-5971
	James Driver	(859) 244-2449
Washington	Clark Fletcher	(425) 489-4042
West Virginia	James Driver	(859) 244-2449
	Patsy Kerns	(304) 561-3010
Wisconsin	David Rasmussen	(262) 513-3424
Wyoming	Dwayne Jacobs	(307) 672-7425 33

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Indian Tribal Governments: Supplemental Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009

Wendy S. Pearson

June 15, 2011

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Table of Contents

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I. Introduction

A. Executive Summary

The Indian Tribal Governments subgroup of the Advisory Committee on Tax Exempt and Government Entities (ACT) reported in 2010 on the implementation of Tribal Economic Development Bonds (TEDBs) under the American Recovery and Reinvestment Act of 2009 (referred to hereafter as the "ACT 2010 Report"). *Indian Tribal Governments: Report on the Implementation of Tribal Economic Development Bonds*, June 2010. This report is a supplement to the ACT 2010 Report.

As we concluded in the ACT 2010 Report, TEDBs represent an important contribution to exempt financing opportunities for Indian tribal governments. However, TEDBs do not go far enough to give tribes adequate access to low cost capital in order to address their vast unmet economic development needs. Tribes had an opportunity to respond to a survey from Treasury about the TEDBs in this past year. (Department of the Treasury, "Tribal Economic Development Bonds," Federal Register/Vol. 75, No. 132/Monday, July 12, 2010/Notices.) The consistent themes of responses to Treasury were as follows: 1) the present iteration of the TEDBs program requires modification to become more useful to the tribes, 2) the Code Section 7871(c) custom-based "essential governmental function" limitation continues to have a chilling effect on tribal financing and must be repealed and replaced with Code Sections 141 to 150 amendments permitting tribes at least the same access to exempt financing as enjoyed by state and local governments, and perhaps even greater financing options, and 3) more must be done as a policy matter to facilitate and subsidize economic development in Indian country.

The past year has shown uneven and slow progress with TEDBs issuances. A majority of the TEDB allocations from the 1st tranche will be forfeited. There are many reasons for this. Tribes and the tribal finance community confirm that many of the causes are due to fundamentals that the TEDB legislation does not address, as reported in the ACT 2010 Report. See, e.g., ACT 2010 Report, Barriers to Tribal Access to Tax Exempt Bond Markets, pp. 33-38. These problems were echoed in the comments to Treasury. The TEDB program also got off to shaky start due to misunderstanding about the TEDB program, misinformation about the allocation process, and simply bad timing for a wary capital market. While the past year has demonstrated a proven demand for the TEDBs, it has also shown that there are impediments to successful TEDB issuances that must be addressed by the IRS, Treasury and Congress.

This report seeks to highlight the developments of the past year to facilitate a meaningful evaluation of the TEDB program. While this report identifies a number of issues that must be taken up as a matter of policy, there are a number of immediate practical fixes to the TEDB program that ACT recommends the IRS initiate. First and foremost, the ACT urges Treasury and the IRS to consult with the tribes as to necessary next steps for optimizing TEDB issuances and for increasing tribes' access to tax exempt financing in general. This includes consultation to determine a reallocation methodology for the TEDB volume, as

well as consultation on the pending Section 7871 regulation project.[1] Second, the IRS should conduct education and outreach to all the tribes to clarify misunderstanding within the tribal community about the use and opportunity of the TEDB program. Finally, there are a couple technical issues pertaining to the gaming restriction and refinancing that may require clarification.

B. Sources and Methods

ACT surveyed tribal governments and their representatives for their direct input on this report. ACT also sought input from tribal associations such as National Congress of American Indians (NCAI) and the Native American Finance Officers Association (NAFOA). ACT reviewed all comments sought and received by the Department of Treasury to assist it in developing its Congressionally-directed report regarding the Code Section 7871(f) bond provisions under the American Recovery and Reinvestment Act ("ARRA"). ACT consulted with underwriters, banks, bond financing experts, current tribal bond holders and other industry representatives involved in tribal bond issuances. ACT would also like to acknowledge the helpful assistance of Cliff Gannett, Director of Tax Exempt Bonds office of IRS and Christie Jacobs, Director of Indian Tribal Governments office of IRS.

C. Background

Section 1402 of Title I of Division B of the American Recovery and Reinvestment Act of 2009, Public Law No. 111-5, 123 Stat. 115 (2009) ("ARRA"), added a $2 billion bond authorization for a new temporary category of tax-exempt bonds for Indian tribal governments, known as "Tribal Economic Development Bonds," ("TEDBs") under Section 7871(f) of the Internal Revenue Code ("Code") to promote economic development on tribal lands. In general, new Section 7871(f) regarding Tribal Economic Development Bonds gives Indian tribal governments greater flexibility to use tax-exempt bonds to finance economic development projects than is allowable under the existing standard of Section 7871(c).

The more flexible standard under new Section 7871(f) generally allows Indian tribal governments to use tax-exempt bonds under a new $2 billion volume cap to finance a broader range of governmentally-used economic development projects and qualified private activities (excluding certain gaming facilities and excluding projects located outside of Indian reservations under Section 7871(f)(3)(B)) under comparable standards for which state or local governments are eligible to use tax-exempt bonds under Section 103. In addition, Tribal Economic Development Bonds may be issued as Build America Bonds under Section 54AA upon satisfaction of the additional eligibility requirements for Build America Bonds. See IRS Chief Counsel Advice No. AM 2009-14 (October 26, 2009).

Section 7871(f)(1) requires Treasury to allocate the $2 billion national volume cap for Tribal Economic Development Bonds among Indian tribal governments in such manner as

[1] Announcement 2006-59, 2006-2 C.B. 388., REG. 118788-06, 71 Fed. Reg. 45474

Treasury, in consultation with the Secretary of the Interior, determines to be appropriate. Pursuant to Notice 2009-51, 2009-28 IRB 128 (July 13, 2009), Treasury and the IRS solicited applications for allocation of the $2 billion in bond volume cap of Tribal Economic Development Bonds and provided guidance on the application procedures, deadlines, forms, and methodology for allocating this bond volume cap. Generally, Treasury employed a pro rata allocation method to allocate this bond volume cap in two separate $1 billion phases, subject to specified maximum allocations for any particular Indian tribal government. Treasury and the IRS announced the results of the two phases of Tribal Economic Development Bond allocations in IRS News Release 2009-81 (September 15, 2009) and IRS News Release 2010-20 (February 11, 2010). Both phases were fully subscribed, with demand exceeding the volume cap.

The ACT prepared a report on the TEDBs in 2010. *Indian Tribal Governments: Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009,* June 2010 ("ACT 2010 Report"). In that report, the ACT studied the TEDBs provision and the history of tax-exempt financing rules, regulations and legislation applicable to tribes for the purpose of evaluating the potential for TEDBs and to make recommendations regarding necessary changes to augment tax-exempt financing opportunities for tribes in order to facilitate much needed economic development in Indian country. In that regard, the ACT 2010 Report adopted and confirmed the findings of the ACT Report of 2004 which recommended, in principal part, that the "essential governmental function" test under I.R.C. § 7871(c) should still be repealed. TEDBs, we concluded, would not go far enough to put tribes at least in parity with state and local governments in terms of their opportunity for financing projects through tax exempt financing.

ACT 2010 Report was intended to provide Treasury with information to assist in the development of Treasury's recommendation. The principal conclusions of the ACT 2010 Report were as follows:

1. The ACT 2010 Report recommended that Treasury report to Congress that there is a demonstrable need for TEDBs.
2. The 2010 report emphasized there is a strong need for tax-exempt financing in Indian country.
3. The depth and breadth of need for infrastructure and economic development in Indian country is longstanding and well documented.
4. For the promise of ARRA to realize itself, more time will be needed to allow tribal tax-exempt issuances to find their place in the national capital markets.
5. There remain asymmetries between tribal governments and state governments that will affect TEDBs' marketability and feasibility and, consequently, their value to tribes as a financing vehicle. We described some of the asymmetries and urged that those asymmetries will take time to resolve themselves, and may require more legislative and policy action.
6. Changes in executive policy and, possibly, enactment of additional laws would still be required to truly put tribes on an equal footing with state and local governments may also be required. Specifically, the effect of TEDBs on

IRC 7871(c) financing could not be known at the time and may require further Congressional action to remedy the overly restrictive "essential governmental function" standard.

7. Finally, ACT advocated for continuing consultation between Treasury and the tribes on all matters relating to the use and efficacy of TEDBs and tax-exempt financing for tribes, along with a collaborative approach from IRS in handling compliance matters relating to TEDBs.

II. Developments Since the ACT 2010 Report

The ACT wishes to address three principal developments since passage of both the Tribal Economic Development Bond provision of Section 7871(f) and the ACT 2010 Report, namely: (1) the status of the Secretary of Treasury's (Treasury) report to Congress mandated by Section 7871(f), (2) credit market activity involving TEDB issuances and, (3) the IRS' administrative extension of time for issuance of the first tranche of TEDBs. These developments shed light on the many issues affecting the utility and viability of the TEDB program. In addition, they lend support to the conclusion of the 2010 ACT Report that the TEDB program needs more time to prove its worth and, indeed, may not go far enough to facilitate much needed economic development in Indian country.

A. Development of the Report to Congress by the Secretary of Treasury

On July 12, 2010, Treasury issued a notice seeking comments from Indian Tribal Governments and the general public regarding the Tribal Economic Development Bond provision of Section 7871(f).[2] The implementing legislation for Section 7871(f) directs the Secretary of Treasury to make a study "of the effects" of Section 1402, "including the Secretary's recommendations" regarding Section 1402. American Recovery and Reinvestment Act of 2009 (ARRA), Section 1402.[3] In a summary of this ARRA provision, the House Ways and Means Committee and the Senate Finance Committee indicated that, in particular, Treasury should study whether to repeal on a permanent basis the existing more restrictive "essential governmental function" standard for tax-exempt governmental bond financing by Indian tribal governments under Section 7871.

Treasury's solicitation for comments was specifically made in furtherance of the objectives of Executive Order 13175 under which Treasury consults with tribal officials in the development of federal policies that have tribal implications, to reinforce the United States government-to-government relationships with Indian tribes, and to reduce the imposition of unfunded mandates upon Indian tribes.[4] As of the writing of this report, Treasury has not completed its report to Congress.

What is apparent from its notice soliciting comments is that Treasury is engaging in a fairly expansive investigation of Section 7871 and its effect on tribal governments' access to low-cost capital for economic development purposes. According to bond practitioners, "The list of specific requests shows a very thorough approach to tribal bonds and provides tribal governments with the opportunity to make their case."[5] Further, the focus of Treasury's queries in fact highlight numerous aspects of current tax-exempt financing rules and regulations applicable to tribal governments that are not in parity with those applicable to state and local governments.

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[2] Federal Register, Vol. 75, No. 132, Monday, July 12, 2010, Notices

[3] Pub. L. No. 111-5, 123 Stat. 115 (2009).

[4] Federal Register / Vol. 75, No. 132 / Monday, July 12, 2010 / Notices.

[5] Linda B. Schakel, "Tax Lines," *The Bond Lawyer*, Summer/Fall 2010.

The general concepts evaluated by Treasury were: 1) whether to eliminate the Section 7871 "essential governmental purpose" test and allow tribal governments to issue tax-exempt financing in the same way that state and local governments are permitted, 2) whether tribal governments should be permitted to issue private activity tax-exempt bonds in the same way that state and local governments are permitted and, 3) whether the limiting restrictions on the use of TEDBs for gaming or for projects off the reservation should be modified. The specific questions put by Treasury were as follows:

1. In general, should consideration be given to changing the law permanently to apply the standard described above, applicable to state and local governments under Section 141, with respect to tax-exempt bond financing for Indian tribal governments (rather than the existing essential governmental function standard under Section 7871(c))?
2. Would focusing on Indian tribal governmental use of bond-financed facilities (rather than essential governmental functions) under the standard applicable to state and local governments provide Indian tribal governments with a sufficiently workable and flexible standard for tax-exempt governmental bond financing?
3. In determining qualified governmental sources of payment for tax-exempt governmental bonds for Indian tribal governments, should special consideration be given to any unique sources of revenue for Indian tribal governments, including (i) income derived from tribal lands held in trust by the Department of the Interior, (ii) state and local government revenues from oil, gas, or other natural resources on Indian tribal government lands, or (iii) revenue derived from gaming or other tribally owned corporate interests, in comparison to the general tax-based sources of revenue for state and local governments?
4. Should consideration be given to changing the law permanently to authorize Indian tribal governments to use qualified tax-exempt private activity bonds for the same types of projects and activities as are allowed for state and local governments?
5. Are there any specific additional types of projects or activities beyond those allowed for state and local governments for which Indian tribal governments should be authorized (or not authorized) to use qualified tax-exempt private activity bonds (i.e., in which private business ownership, leasing, or other private business use of the bond-financed projects would be permitted) in light of their special needs or unique circumstances? For example, would federal corporations chartered under Section 17 of the Indian Reorganization Act of 1934 (25 U.S.C. 477) require special provisions to use qualified tax-exempt private activity bonds?
6. If Congress were to determine that it was necessary to impose some form of bond volume cap on the use of qualified tax-exempt private activity bonds by Indian tribal governments similar to that imposed on state and local governments, how specifically should such a bond volume cap be structured to best promote fair, effective, and workable use? One option would be to

allocate the private activity bond volume cap among Indian tribal governments based on population, coupled with some minimum allocation for small Indian tribal governments. Another option, similar to that used for the $2 billion Tribal Economic Development Bond authorization, would be for Treasury (or another federal agency, such as the Department of the Interior's Bureau of Indian Affairs) to allocate the volume cap using some prescribed method, such as a population-based allocation method that incorporates an adjustment factor to take into account holdings of land and other natural resources in the case of tribes with small populations. Suggestions for other alternative allocation methods are welcome.

7. Should the prohibition on the use of Tribal Economic Development Bonds to finance gaming facilities be modified to address special needs or unique circumstances of Indian tribal governments?
8. Should the limitation on use of Tribal Economic Development Bonds to finance projects that are located outside of Indian reservations be modified to address special needs or unique circumstances of Indian tribal governments? For example, should consideration be given to allowing the use of Tribal Economic Development Bonds to finance projects within some prescribed reasonable proximity to Indian reservations or projects located on land owned by Indian tribal governments which has not formally been designated in trust as part of an Indian reservation?

Twenty-seven (27) comments were submitted by tribes. Some of the individual submissions represented collaboration among numerous tribes and/or statement of affiliated tribes. In addition, the National Congress of American Indians (NCAI) submitted comments as the representative congress of all American Indian tribal governments based on input from tribal representatives, industry experts in tribal finance and attorneys practicing in the area of tribal finance. The comments can be found at www.regulations.gov, document identification "TREAS-DO-2011-0001-0002.1." The comments were thoughtful and, in all material respects, uniform in their responses. ACT incorporates these comments into its report and commends the reader to them.

The overarching themes from these comments support a conclusion that the TEDB program is a good start, but does not go far enough in its present iteration to alleviate the vast unmet economic development needs of all the federally recognized tribes. Further, tribes still desire and need at least parity with states in terms of their access to low cost capital, and the TEDBs do not accomplish that parity. Finally, more may need to be done by Congress and Treasury to facilitate and subsidize economic development in Indian country.

Based on their comments, tribes generally support the following actions.

i) The Essential Governmental Function Test Should be Eliminated

Section 7871(c) limits the use of tax-exempt bonds by Indian tribal governments to the financing of certain activities that constitute ''essential governmental functions,'' and

Section 7871(e) further limits those functions to ones customarily performed by state and local governments with general taxing powers (limited manufacturing facility projects are also permitted). As Treasury suggested in its notice, "The custom-based essential governmental function standard under Section 7871(e) has proven to be a difficult administrative standard and has led to audit disputes, based on difficulties in determining customs, the evolving nature of the functions customarily performed by state and local governments, and increasing involvement of state and local governments in quasi-commercial activities." Federal Register, Vol. 75, No. 132, Monday, July 12, 2010, p. 39730.

Notably, the question whether the "essential governmental function" should be repealed, was the opening query in Treasury's request for comments. *Id.* Predictably, the tribes unanimously answered that the essential governmental function standard should be eliminated. Achieving at least parity with state and local governments in terms of access to low cost capital for more wide-ranging economic development projects has been an unmet goal of the tribes for decades.[6]

In all instances, tribes conveyed that the essential governmental function standard under Section 7871(c) is unworkable, unfair, has a chilling effect on financing, and in some respects interferes with the efficacy of TEDBs. A fundamental reason for these problems is the fact that determination of whether a tribal issuance meets the custom-based essential governmental function test is made on a case-by-case basis. The state of the law for what qualifies under Section 7871 is unclear; no regulations have been issued on this subject. An Advance Notice of Proposed Rulemaking issued in 2006 identifies the test which the IRS will follow in making its determination, namely restraint from commercial and industrial enterprises and establishing that the subject activity is conducted regularly by many states. Announcement 2006-59, 2006-2 C.B. 388., REG. 118788-06, 71 Fed. Reg. 45474. Later private letter rulings elaborate this further. See ACT 2010 Report, pp. 8-9. Nevertheless, neither the private letter rulings nor the advance notice of rulemaking serve as definitive authority. Thus, qualification for any one project remains uncertain and, at best, takes additional time and money to acquire a ruling from the IRS. Some practitioners in the banking and finance industry suggest that some tribes may have applied for an allocation of TEDBs even though their project would probably likely qualify under the essential governmental function standard, because TEDBs are more certain and straight forward than the cumbersome EGF test. Accordingly, some practitioners suggest TEDB volume cap may have been used "unnecessarily," because of the uncertainty of the essential governmental function standard, and as such, it should be eliminated because it interferes with the efficacy of TEDBs.

There was strong support in the comments for Treasury's suggestion that the state or local governmental standard (under Section 141 of the Code) for issuing tax-exempt obligations

[6] State and local governments have been favored for years with access to tax exempt financing for a variety of public and qualified private activities, including commercial projects such as hotels, convention centers, golf courses, recreation facilities, and the like to promote their economic development. Tribes, on the other hand, have been precluded. U.S. GOV'T ACCOUNTABILITY OFFICE, FEDERAL TAX POLICY: INFORMATION ON SELECTED CAPITAL FACILITIES RELATED TO THE ESSENTIAL GOVERNMENTAL FUNCTION TEST 1, 3-5 (2006).

should instead be the standard for Indian tribal governments, replacing the "essential governmental function" standard. State and local governments generally can use tax-exempt governmental bonds to finance an unspecified broad range of projects and activities so long as: (1) not more than 10 percent of the bond proceeds are used for private business use, and (2) the debt service on no more than 10 percent of bond proceeds is payable or secured from payments or property used for private business use. 26 U.S.C. Section 141(b).

For tribes, applying the same tax-exempt financing standard to them, as applies to state and local governments, will put them on at least the same legal footing and eliminate discriminatory treatment. And, it is generally expected that tribes' access to tax-exempt financing will be enhanced under the Section 141 standard as it is a standard which is well-understood in the finance community and more easily administered by the IRS than the essential governmental function standard.

However, tribes suggested that several considerations warrant expanding their access even further than state and local governments. Thus, a modified standard from Section 141 should be considered. Treasury requested comments about peculiar needs of tribes, as well as unique sources of revenue, that should be considered in developing a standard for tax-exempt financing. Tribes suggested generally the following considerations support the notion of expanding their access to low cost capital:

a) SPECIAL ROLE OF INDIAN TRIBAL GOVERNMENTS

Tribal governments are different from state and local governments in both form and purpose. Tribal governments take many different forms and are not uniform among the 563 federally recognized tribes. Because tribal governments must direct both governmental and commercial functions, they rely on subordinate boards, committees and commissions for political governance. Tribal governments also form enterprises and other entities to carry out essential governmental functions.

Tribal governments play an essential role in supporting their citizens. Tribal governments and the entities they create often need to engage in commercial and industrial activity in order to create jobs for tribal members and to generate revenue to support the general welfare of the members. To that end, tribal companies provide the much needed revenue to support a tribe's governmental function. There is no "private sector" to do this within an Indian reservation. Many tribes form Section 17 corporations to fund their government. 25 U.S.C. 477. [7] The Indian Reorganization Act specifically recognized that Section 17 corporations could help tribes revitalize their communities and economies and were intended to address poverty and lack of resources. Accordingly, tribes overwhelmingly suggested in their comments that Section 17 corporations, as wholly owned entities of the tribal government, should be permitted to issue tax-exempt financing as they are integral to the tribal government and perform an essential governmental function.

[7] Wheeler-Howard Act of 1934, Ch. 576, 48 Stat. 984.

b) TRIBES SUFFER FROM VAST UNMET ECONOMIC DEVELOPMENT NEEDS

Comments from the tribes reiterated the fact that tribes lack basic infrastructure, and their economic development needs are vast. See also ACT 2010 Report at Section VI. This can only be remedied with access to less expensive capital. For that reason, tribal governments suggest that their access to tax-exempt financing should be broader than state and local governments.

c) TRIBES DO NOT POSSESS THE SAME RESOURCES AS STATE AND LOCAL GOVERNMENTS FOR SECURING FINANCING

A fundamental problem is that tribes lack a tax base. The general lack of commercial activities on most reservations restricts many tribes from imposing excise taxes. Further, there is a disincentive to tax non-tribal businesses located on the reservation because they may be subject to taxation by the relevant city or county, leaving the potential for, or perception of, double taxation if the tribes levy taxes. Tribes also lack the ability to impose property taxes. See ACT 2010 Report, Section VII.

So, securing financing presents unique challenges for tribal governments, unlike state and local governments who routinely secure financing with tax revenue. Thus, tribal governments need to generate revenue from other sources. Because of that, they suggest that tribal governments should not be unduly fettered from engaging in commercial and industrial activities. The tribes suggest there are enough practical and regulatory safeguards in place that would circumscribe their use of commercial and industrial activities in competition with private business. *Citing, e.g.,* Treasury Regulation 1.141-3 and Revenue Procedure 97-13. Further, tribal financing of commercial and industrial facilities, as a means of developing more sustainable economies on their reservations, should be viewed no differently than the issuance of governmental bonds by state and local governments to finance ports, sports stadia, convention centers, campgrounds, and other projects.

In addition, tribes point out that tribal gaming revenues bear a similarity to the revenues received by many states from state lottery and other commercial or proprietary operations. While tribal gaming revenue is not necessarily a pervasively sufficient source to pledge for financing purposes, it is a very important source for many tribes. Accordingly, all tribes suggest that gaming revenue should be a qualified source of payment for tax-exempt financing. As the NCAI suggested, “the development, improvement and expansion of gaming operations, under appropriate circumstances, should, for federal income tax purposes, be viewed, from a functional standpoint, as analogous to the enactment of tax levies by states and localities or the modification of their income tax rates or ad valorem property tax rates, or as the development of other needed revenue streams such as those generated by state lotteries or other commercial or proprietary operations.” See Comments, NCAI, Treas-DO-2011-0001-0002.1.

Moreover, tribes suggest that there should be no special consideration given to the source or identity of the Indian tribal governmental revenue and no limitation placed upon what

constitutes a qualified source of revenue. In fashioning a standard for tribal finance, Congress and Treasury should recognize and respect the need for tribal governments to turn to other sources of governmental revenue to pay debt service obligations.

ii) Indian Tribal Governments Should Be Permitted to Issue Tax Exempt Private Activity Bonds.

Current law bars Indian tribes from issuing private activity bonds for anything other than a tribal manufacturing facility. 26 U.S.C. § 7871(c)(2), (c)(3). For state and local governments, Section 141 of the Code provides that numerous specific types of projects and activities may be financed without regard to the level of private involvement. 26 U.S.C. § 141(e). State and local governments can issue qualified tax-exempt private activity bonds under § 141(e) and related provisions for projects and activities, including: (1) airports, (2) docks and wharves, (3) mass commuting facilities, (4) facilities for the furnishing of water, (5) sewage facilities, (6) solid waste disposal facilities, (7) qualified low-income residential rental multifamily housing projects, (8) facilities for the local furnishing of electric energy or gas, (9) local district heating or cooling facilities, (10) qualified hazardous waste facilities, (11) high-speed intercity rail facilities, (12) environmental enhancements of hydroelectric generating facilities, (13) qualified public educational facilities, (14) qualified green buildings and sustainable design projects, (15) qualified highway or surface freight transfer facilities, (16) qualified mortgage bonds or qualified veterans mortgage bonds for certain single-family housing mortgage loans, (17) qualified small issue bonds for certain manufacturing facilities, (18) qualified student loan bonds, (19) qualified redevelopment bonds, and (20) qualified 501(c)(3) bonds for the exempt charitable and educational activities of § 501(c)(3) nonprofit organizations. 26 U.S.C. §§ 141(e), 142.

The comments exhibited unanimous support for Treasury's suggestion that Indian tribal governments be allowed to issue qualified private activity bonds (PABs) for similar types of projects and activities as are allowed for state and local governments, with certain clarifications to implement the use of such bonds in light of the special needs and unique circumstances of tribes. In that regard, tribes suggested that additional types of private activity bonds (PABs) should be authorized for Indian tribal governments (beyond those presently allowed for state and local governments), specifically because of the special needs and unique circumstances of tribes as outlined above. Expanded private activity bond authority will accomplish a great deal to advance tribe's efforts to attract and promote economic development in their reservations and territories.

In terms of expanding the universe of allowable private activity financing, it is suggested that Indian tribal governments should be permitted to issue bonds for the benefit of tax-exempt entities, including Section 17 corporations. Likewise, Section 17 corporations should be treated as if they are the tribal government and, thus, have the ability to issue PABs to the same extent. *Citing*, Private Letter Ruling 9847018 (Nov. 20, 1998) (Section 17 Corporation would be treated the same as the tribe for the purposes of issuing tax-exempt bonds). That is, any tribally chartered corporation or other entity formed under tribal law by and for the tribal government, should qualify as a political subdivision. 26 C.F.R. 1.103-1(b). In that regard, guidance is still needed from the IRS to clarify the status

of tribal instrumentalities. See Office of Tax Policy and Internal Revenue Service, *Update to 2009-2010 Priority Guidance Plan*, General Tax Issues, ¶ 31. Finally, any expansion of private activity bond financing should also ensure and clarify that tribal governments can act as the beneficiary (e.g. a conduit borrower) of qualified tax-exempt private activity bonds to the same extent permitted by a state or local government. TAM 200603028 (does not presently permit tribes to act as a conduit borrower).

In terms of expanding the allowable categories of projects which may be financed by PABs, many of the commenting tribes suggest they should be permitted to finance more commercial and industrial activity than presently permitted under Sections 141 through 146 of the Code, given their staggering economic development needs and other unique circumstances, described above. Tribes are at a disadvantage to engage in the economic development activities considered by state and local governments to be a common exercise of their essential governmental functions. State and local governments are in a different situation than tribal governments given their access to public tax revenues, which permit them more latitude in structuring the financing. Accordingly, it is argued, tribes need special categories of qualified PABs that take into account their special circumstances.

For instance, a suggested standard for tribal PAB financing may be to permit financing of commercial projects that have economic (job creation), environmental and other social value. This could include projects such as renewable energy projects, retail facilities, recreation facilities, tourism facilities, and so on. Some tribes suggest a new category of qualified tax-exempt private activity bonds should be authorized for land acquisition, in particular reacquisition of ancestral homeland which is especially important for tribes with limited usable base for economic development. Further, the expanded exempt financing authority should ensure that projects which improve tribal living conditions will qualify, such as mortgage and residential rental bonds to augment Indian housing, the development of services on the reservation such as health care, and the building of needed infrastructure such as sewer facilities, water facilities, broadband technology, airports, marinas, and roads. Qualified private activity bonds currently permitted under the Code may be sufficient to encompass some of these uses (I.R.C. Sections 141(e), 142), but special consideration should be given to ensure that tribes have ample access to tax-exempt qualified private activity financing which may mean both expanding the universe of “qualified” bonds and addressing the propriety of a volume cap.

Subject to certain exceptions, most types of tax-exempt qualified private activity bonds are subject to annual state bond volume caps based on state populations, with adjustments for inflation and minimum allocations for smaller states, and with three-year carry forward periods for unused allocations. I.R.C. Section 146. For tribes, this type of volume cap formula is unworkable. Most tribes suggested there should be no volume cap on PABs because of tribes’ unique circumstances and historical lack of economic development. Nevertheless, at a minimum any volume cap should be determined based on equitable standards benefiting all federally recognized tribes and based on input from tribes regarding relevant criteria.

iii. Certain Modifications to TEDBs are Warranted

a) RESTRICTION TO PROJECTS ON "RESERVATION" SHOULD BE REPEALED

Section 7871(f)(3)(B)(ii) of the Code includes a restriction that limits the use of Tribal Economic Development Bonds to the financing of projects that are located on Indian reservations (as defined in Section 168(j)). Tribes unanimously agree this provision is too restrictive and unnecessarily circumscribes their options for financing economic development. In response to Treasury's request for comment on whether this restriction should be modified, tribes responded consistently that this provision be repealed.

There are numerous reasons for repealing the "on reservation" restriction. Many tribes have an insufficient land base for economic development, or a land base with very limited uses. Certain tribes, including Alaskan tribes, have no reservation or trust land. Tribes in the process of applying for trust status for reacquired land find the process has been rendered uncertain by recent judicial action. *Carcieri v. Salazar*. 555 U.S. 379; 129 S. Ct. 1058; 172 L. Ed. 2d 791. Tribal lands can be scattered, sliced up and remote, rendering them inadequate for viable economic development. Consequently, many tribes must look to geographic areas outside a "reservation" area for their economic development, which effectively precludes them from using TEDBs. Further, certain tribes' access to TEDB allocation have been delayed as they await action from the federal government to confirm the trust status of their land, or in the case of Alaska natives, to confirm they are permitted to utilize TEDBs. See Section iv.a.*, infra.* So, this "reservation" restriction has, at best, delayed use of TEDB allocations and, at worse, unfairly and unnecessarily denied many tribes the same access to exempt financing as states enjoy, thereby hampering economic development where it is needed the most.

States do not suffer this same restriction where facilities financed by tax-exempt bonds are required to be located within or near the jurisdictional boundaries of the issuer. I.R.C. Section 103. Tribes should be accorded the same flexibility. If necessary, tribes should be permitted at least to show that the project outside the reservation contributes importantly to the tribal community, borrowing perhaps from prior IRS rulings which articulate a "substantial connection" or "nexus" test. See, e.g., Rev. Rul. 77-281, 1977-2 C.B. 31 (relating to "small" issuances). In short, restricting TEDB projects to the "reservation" is arbitrary, unfair, and discriminatory.

b) RESTRICTION AGAINST FINANCING GAMING ACTIVITY IS INCONSISTENT WITH RULES APPLICABLE TO STATE AND LOCAL GOVERNMENTS

Section 7871(f)(3)(B)(i) of the Code prohibits the use of Tribal Economic Development Bonds to finance any portion of a building in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted or housed or any other property actually used in the conduct of such gaming. Treasury has asked whether the prohibition on the use of Tribal Economic Development Bonds to finance gaming facilities should be modified to address special needs or unique circumstances of Indian tribal governments. Federal Register, Vol. 75, No. 132, p. 39733.

Principally, the tribes request at least parity with state and local governments as it relates to exempt financing which may benefit gaming-type operations. While tribes understand there may be policy issues to consider around the use of tax-exempt debt for gaming operations, Congress should revisit the issue with a greater understanding of the place of Indian gaming in discharging the obligations of tribal governments toward their members, and with a greater understanding of the unique circumstances of tribes which already exert practical limits on their access to exempt financing traditionally available to states. One particular factor that some commenters suggest should weigh in the decision is the fact that the Indian Gaming Regulatory Act (IGRA) already adequately circumscribes and aligns the use of Indian gaming revenue toward essential and customary governmental functions. IGRA mandates that gaming profits may only be used for the following purposes: 1) to fund tribal government operations or programs; 2) to provide for the general welfare of the Indian tribe and its members; 3) to promote tribal economic development; 4) to donate to charitable organizations; and 5) to help fund operations of local government agencies. 25 U.S.C. §2710(b)(2)(B). IGRA recognized the vital importance gaming activity could have toward supporting essential tribal governmental functions.

Regardless of any modification that may be made to the gaming restriction applied to TEDBs, tribes indicate that they need further clarification from the IRS on what constitutes a “building” in which class II or class III gaming (as defined in section 4 of the Indian Gaming Regulatory Act) is conducted. Notice 2009-51, section 10, provided a safe harbor definition for what may be considered a building independent from a gaming building:

> As a safe harbor, a structure will be treated as a separate building if it has an independent foundation, independent outer walls and an independent roof. Connections (e.g., doorways, covered walkways, or other enclosed common area connections) between two adjacent independent walls of separate buildings may be disregarded as long as such connections do not affect the structural independence of either wall.

Notice 2009-51, 2009-28 IRB 128.

In practice, this safe harbor test has proved difficult to administer and interpret, and as such, has had a chilling effect on financing. Tribes suggest that clarification is required to confirm that independent buildings can be adjacent to a gaming facility and perhaps physically connected to it, but not be considered a building in which gaming activity is conducted.

iv. Other Legislative and Policy Changes Must Be Considered in Order to Facilitate Tax Exempt Financing by Indian Tribal Governments

Treasury asked tribes whether there are “factors that should be considered in refining the statutory scope of tax-exempt bond financing for Indian tribal governments to better address the special needs or unique circumstances of Indian tribal governments? Such factors might include, for example, special sources of revenue, priority government-like

activities, geographic distribution and legal status of land associated with Indian tribal governments, or credit market access considerations." Federal Register, Vol. 75, No. 132, p 39733.

The following were the principal additional considerations requested by tribes.

a) ENSURE PARTICIPATION OF ALASKA NATIVES IN THE TEDBS

Alaskan tribes (of which there are over 200) believe they have been effectively precluded from meeting the eligibility requirements for issuing TEDBs. This matter definitely requires clarification from the IRS and/or Treasury. As mentioned previously, Section 7871(f)(3)(B) limits use of TEDBs to the "reservation" as defined by Section 168(j)(6) of the Code, which in turn incorporates 25 U.S.C 1903(10) and 25 U.S.C.1452(d). 25 U.S.C. 1452(d) provides:

> (d) "Reservation" includes Indian reservations, public domain Indian allotments, former Indian reservations in Oklahoma, and land held by incorporated native groups, regional corporations, and village corporations under the provisions of the Alaska Native Claims Settlement Act (43 U.S.C.A. §1601 et seq.)

25 U.S.C. 1903(10) provides:

> (10) "reservation" means Indian country as defined in section 1151 of title 18 and any lands, not covered under such section, title to which is either held by the United States in trust for the benefit of any Indian tribe or individual or held by any Indian tribe or individual subject to a restriction by the United States against alienation.

While these definitions may be broad enough to cover land over which a tribe has jurisdiction, but which is not formally held in trust or formally prescribed as a reservation, the matter is not without question for Alaska natives.

In addition to the uncertainty about whether Alaska natives qualify to participate in TEDBs, ACT is aware that there was no participation by Alaska natives in the TEDB allocations due to practical problems. Many were not even aware of the TEDB opportunity, due at least in part to the consequence of their remote locations. Their respective size and geographic location made it impractical for many to respond quick enough to participate. See ACT 2010 Report. Accordingly, Treasury and the IRS should ensure sufficient participation by Alaska natives in any further reallocation of TEDB volume. *Infra,* at Section iv.a.

b) ALLOW THE USE OF FEDERAL GUARANTEES

Tribes emphasize that refined tax law authority will likely not be sufficient to meet their economic development needs effectively, if not coupled with greater market access. As ACT reported in 2010, tribes simply lack the kind of resource and tax base needed to secure their debt obligations. ACT 2010 Report, pp. 33-35. Tribes echoed this problem in their comments to Treasury.

Accordingly, tribes require additional options for securing debt. To that end, tribes unanimously requested that consideration be given to the use of federal guarantees in connection with tax-exempt tribal financing. Current law does not permit federal guaranty of tax-exempt bonds except in limited circumstances, such as housing bonds. 26 U.S.C. 149(b); see also, 25 U.S.C. 1486 and ACT 2010 Report, p. 35. Tribes suggest a special exception relating to tribal exempt financing is warranted due to their special needs (gross unmet need for economic development) and unique circumstances (no access to meaningful collateral). Without something like a federal guaranty, tribes will continue to experience very limited credit market access.

c) REPEAL THE REGISTRATION REQUIREMENT FOR TRIBAL SECURITIES

Tribal governments are not exempted from the registration and disclosure rules set forth in the Securities Act of 1933, whereas state and local governments are exempted. Securities Act of 1933, 15 U.S.C. 77c(a)(2), (b). Thus, tribes must either bear the registration costs or issue bonds into the private placement market, which generally provides inferior terms. See ACT 2010 Report, p. 36. Tribes confirmed (in their comments to Treasury) that the unequal treatment given them under the Securities Act of 1933 makes tribal financing more costly and unfairly discriminates against them.

B. Market Activity Involving Tribal Economic Development Bonds

ACT sought the input of various representatives from the general banking and finance community, as well as tribal organizations, to ascertain the current state of TEDB activity in the credit market.[8] What we determined generally is that there have been only a handful of successful TEDB financings, to date. A few financings were issued as bonds and a few financings were structured as a bank loan. There are at least a dozen pending projects for which a TEDB issuance is expected. See also, *infra,* at Section II.C. There are a number of factors which explain the relatively nominal credit market activity involving TEDBs.

i) TEDBS Are Not Well Understood

As predicted in the ACT 2010 Report, the concept of TEDBs is taking a while for both the tribes and the credit market to vet. Representatives of the finance community report that there was a great deal of misinformation (from unidentified sources) about applying for TEDB allocations that circulated early on in the process. And, there remains a good amount of misunderstanding among tribes, investors and lenders about the use of TEDBs. In fact, some tribes thought that the TEDB allocations were a form of federal grant. Accordingly, some form of education process is warranted. This will, of course, add to the length of time needed to evaluate the efficacy of TEDBs.

It will also take time for tribes to realize the full potential that TEDBs may hold for them. To date, there is little information available about how TEDBs are being successfully utilized.

[8] The ACT would like to thank representatives from the Native American Finance Officers Association (NAFOA), Sovereign Finance, Key Bank, and Jeffries & Co. for providing comments about the credit markets and TEDB activity.

Some issuances do not show up in the market as "TEDBs," but rather as Build America Bonds, Variable Rate Demand Bonds, bank loans, and so on. So, there is little chatter in the market about "TEDB" successes, leaving a misperception among tribes and investors that TEDB allocations cannot be effectively utilized.

ii) Capital Market Conditions Have Not Been Favorable

With respect to the general capital market conditions over the last year, experts in tribal finance report that TEDBs came onto the scene during a particularly bad period for the capital markets. Indeed, the overall market conditions may have had the greatest dilatory effect on tribal issuances than any other factor, according to tribal finance experts. In addition to the general problem of tight credit access a general lack of risk tolerance among investors and banks, access to low tax-exempt rates was challenged because the benchmark exempt rates hovered around the Treasury rates. This made it difficult to plan for exempt financing. As of the date of this report, the rates are normalizing and investors are looking to put capital to work, which should help exempt issuances.

Compounding the problems for tribal issuers in a recession economy, is the fact that the universe of potential investors for tribal financings is often limited to investors of high yield bonds and Rule 144A Private Placements due in large part to speculative credit ratings for most tribes.[9] This is the case even though most of the tribes (principally gaming issuers) that have issued taxable or tax-exempt debt during the past decade exhibit strong financial characteristics relative to other corporate or municipal issuers in their rating category. (See "Fitch Ratings"). In fact, there had been no major tribal bond defaults, until recently. However, the timing could not have been worse for four high-profile tribal bond defaults to occur in 2009 and 2010, at the time TEDBs were first authorized. Although these defaults are being restructured, there has been negative publicity and consequential negative market perception of tribal issuers.[10] So, the already small universe of investors in tribal debt obligations is wary. Experts in tribal finance hope, however, that the successful restructuring of these defaulted obligations (three out of four have been restructured as of the writing of this report) will give investors confidence that tribes will honor their debt obligations.

Beyond the dilatory effects of a bad market and some bad publicity, there are also practical problems. For example, as the amount being financed gets smaller ($50 million is a benchmark), the investor pool gets smaller. Tribes were limited in the first tranche of TEDB allocations to $22.5 million. Thus, the already limited pool of investors in tribal debt was whittled even further. Further, the lack of repayment sources (namely, tax revenue) to pledge, means that TEDBs will fail, typically, at the underwriting stage. This is a fundamental problem that must be addressed, as argued previously.

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[9] Tribes with stronger credit profiles may tend to gravitate more toward commercial bank loans.

[10] Investor confidence in tribal issuances was also rocked by the court decision in *Wells Fargo v. Lake of the Torches Economic Development Court,* 677 F. Supp. 2d 1056 (W.D. Wisconsin 2010) which invalidated the tribe's $50 million bond indenture because of a failure to obtain advance approval of a trust indenture agreement as required under the Indian Gaming Regulatory Act.

iii) Inadequate Amount of TEDB Allocations Has Caused Complications

Many tribes did not receive the full amount of TEDB allocation requested. This has resulted in either making the economics of their projects nonviable, or has resulted in very complicated transactions which cobble together financing from several sources to reach the needed amount. That complication has added both cost and an extraordinary amount of time to finalize a financing deal involving TEDBs. The small allocations also made it difficult for some tribes to justify a refinancing with their TEDB allocation, as the economics were not suitable given the weakness of the tax-exempt market and the cost of refinancing less than the full amount requested and needed.

There are also a number of circumstances peculiar to individual TEDB allocations that lend to the low TEDB issuances, to date. For example, hearsay reports from the tribal finance community suggest that some tribes were wrongly advised by professionals to request an allocation as a place-holder to ensure access. This means that some allocations probably went to projects that are unlikely to be viable or completed, certainly within the time frame for issuance allowed under Notice 2009-51. Also, some tribes who received allocations may not be able to issue by the deadline, not because their projects lack viability, but because they are still awaiting the federal government's trust status determination as to the subject property. See, *supra,* Section iii.a. regarding problems in the wake of *Carcieri v. Salazar*. Some tribes requested TEDBs to refinance a project, but because they did not receive the entire allocation requested, the refinance was not ultimately economical. Finally, because some tribes did not receive the total allocation requested, their initial project assumptions have to be altered to allow time for existing loans to expire. These are just a few examples of no doubt a plethora of unanticipated causes and conditions for a relatively low TEDB success rate thus far.

C. IRS Extension of the Issuance Date for the First Tranche

The IRS issued Announcement 2010-88 on November 22, 2010. IRB 2010-47. The Announcement applies to the first tranche of TEDB allocations which were required to issue by December 30, 2010. It does not apply to the second tranche. The IRS gave tribes an automatic six (6) month extension unless the tribe notifies the IRS that they do not intend to use the allocation, in which case it will be forfeited.

Tribes may receive an additional six month extension to December 31, 2011, if they submit a written request by March 30, 2011, which includes:

> (1) a copy of the allocation letter from the IRS for the allocation to which the request relates; and
> (2) statements from an official of the Indian tribal government duly authorized to execute legal documents on behalf of the Indian tribal government in making the request, made under penalty of perjury, including:
>
> > (a) a statement explaining the reason for the extension of time,

(b) a statement that the Indian tribal government reasonably expects to issue Tribal Economic Development Bonds pursuant to such allocation on or before December 31, 2011, to finance the project described in the Indian tribal government's original application ("Application"), [note, insubstantial deviations from the project described in the application are permitted as set forth in Section 8 of Notice 2009-51], and
(c) a statement that such official has knowledge of the relevant facts and circumstances relating to the request and the Application, has examined the request and the Application, and that the information contained in the request and the Application is true, correct, and complete.

The IRS received sixteen (16) requests for extension by the March 30, 2011, deadline. Representatives in the tribal finance community predict that a few TEDBs will be issued by the June 30, 2011, deadline, so no extension was requested for those. According to the Announcement, allocations not issued by the revised dates of June 30, 2011, or December 31, 2011, as the case may be, are forfeited. There were a total of 58 allocations in the first tranche. This means that roughly two-thirds (2/3) of the first tranche allocations will be forfeited.

No re-allocation method for forfeitures has been devised by the IRS, to date.

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III. Next Steps

A. What Conclusions Can Be Drawn From These Developments

It is difficult to draw any certain conclusions at this juncture about TEDBs as a viable finance vehicle for tribes. There has been a low issuance rate of TEDBs and there will certainly be a considerable dollar amount of the $2 billion volume cap that will have to be dealt with upon the forfeiture of 1st and 2nd tranche allocations. A number of external circumstances certainly conspired to impede the successful implementation of TEDBs. First, was the timing. The TEDB program rolled out under highly unfavorable credit market conditions. The allocation process similarly proved unsuccessful. The implementing legislation provided the IRS with no instructions regarding how to allocate the $2 billion volume cap. After soliciting comments from the tribes, the IRS fashioned an allocation methodology that was responsive to the tribes concerns, with a goal particularly to achieve equitable access as soon as possible. As it turns out, that allocation methodology created its own problems as described previously, *supra* at Section II.B. And, there is an education process for both the tribes and the credit markets that must occur before TEDBs can be optimally utilized.

Nevertheless, what is clear from the comments of tribes and the finance community is that TEDBs are a much needed addition to the arsenal of tax-exempt financing vehicles available to tribal governments and the program should be made permanent. That said, it is also clear from the comments that the current iteration of the TEDB program has some inherent problems and unworkable limitations. If TEDBs are retained, legislative action is necessary to modify the TEDB program, as discussed earlier in this report. In addition to a less encumbered TEDB program, tribes should be accorded at least the same access to tax-exempt financing as state and local governments. To that end, the Code Section 7871(c) custom-based essential governmental function test must be repealed. The Code Section 141 through 150 exempt financing provisions that presently apply to state and local governments should apply equally to tribes with additional clarifications and modifications that account for tribes' unique circumstances and special needs.

The ACT understands that the above legislative and policy recommendations are beyond the scope of authority and action by the IRS. There are, nevertheless, additional administrative measures which the IRS can take to facilitate TEDB issuances and to augment tribal exempt financing generally, as follows.

B. Consult with Tribes to Determine a Reallocation Method for Forfeited TEDB Allocations

Tribes have proved an overwhelming need for an exempt financing tool like TEDBs through their oversubscription of both tranches of allocations. However, the low issuance rate proves, among other things, that the allocation process has not been workable. The IRS recognizes that the manner and method of TEDB allocations must be reconsidered in order to optimize TEDB issuances. To that end, the IRS has indicated that it will seek

consultation with the tribes on the process of reallocating forfeited allocations of volume cap.

In their comments to Treasury, tribes likewise suggest that the allocation process requires modification and that tribes must participate in the determination of that process. Comments to Treasury did not reflect uniform suggestions among tribes for an alternative allocation methodology. Nevertheless, most suggest that the allocation process may need to be more qualitative to ensure that viable projects receive an adequate allocation to ensure a successful issuance. Representatives from tribal finance suggest that many tribes are presently in a position to use more TEDB allocations once they become available. They likewise urge that successful TEDB issuances will help educate the investor base about TEDBs and help to generate some positive momentum in the markets.

In addition, tribes need to rely on a determinable re-allocation process so that they can adequately plan for their financing. Tribes cannot engage in long term planning without knowing what will happen with unused allocations, especially for those tribes who only received a portion of the TEDB allocation requested in the 1st and 2nd tranches. Such a process may entail some sort of rolling allocation which requires tribes to issue within a certain time period or forfeit their allocation, making the forfeited amounts available for application. Whatever the re-allocation process, tribes want to ensure equitable access.

The reallocation methodology will need to be decided as quickly as possible, while allowing adequate time for meaningful consultation. ACT urges Treasury and the IRS to initiate the consultation process immediately. Based on their comments to Treasury, tribes stand ready to engage in the consultative process quickly in order to facilitate immediate use of available TEDB volume cap.

C. There are Additional Clarifications Possible Within the Current TEDB Framework

The National Association of Bond Lawyers (NABL) suggests TEDBs legislation should be clarified to confirm that the volume limitation should not be required for refunding of TEDBs. NABL, *ARRA Technical Corrections Project,* June 2010. Tribal governments can use tax-exempt bonds in “refunding issues,” as defined in § 1.150-1(d) of the Income Tax Regulations, to refinance prior bonds, subject to certain restrictions, including a restriction under § 149(d) against not more than one “advance refunding issue,” as defined in § 1.150-1(d)(4), for tax-exempt governmental bonds, and a prohibition against any advance refunding issue for tax-exempt qualified private activity bonds. 26 U.S.C. 7871(f)(3)(B).

As mentioned previously, recent guidance from the IRS, with respect to the gaming restriction, has caused some confusion and uncertainty for tribes as to what may or may not be subject to that restriction. Accordingly, the IRS should clarify its safe harbor definition of an “independent building” to which the gaming restriction does not apply. See Notice 2009-51, Section 10.

The IRS should also conduct education and outreach regarding the TEDB program. As indicated, there is a good deal of misunderstanding and misinformation about the TEDB

program. TEDBs will not likely see more use or success until the tribes and the credit markets have a better understanding of their place and potential in tribal financing. Particular outreach efforts are required for Alaska natives due to their lack of participation and the need to clarify their access to TEDB volume.

D. There are Additional Administrative Actions Possible to Facilitate Tax-Exempt Financings by Tribes

Rulings by the IRS, in the past few years, appear to expand the opportunities for exempt financing under Code Section 7871(c), as compared to earlier rulings. See ACT 2010 Report, p. 9. For instance, the IRS has allowed for tax-exempt financed construction and operation of a tribal museum, cultural center, government offices, emergency services building, all contiguous to a casino. The IRS noted that these projects were not commercial or industrial in nature, even though infrastructure improvements to support these developments would also serve the casino. The IRS also permitted a taxpayer to finance an electric-generating facility through tax-exempt financing where a political subdivision of the tribe was the borrower and the issuer of the bond was a county electric district created by the state. The electricity was to be provided to the reservation on a non-profit basis. The IRS held this was an activity that is conducted regularly by state and local governments, and is not commercial in nature due to the non-profit aspect of the service.

Despite a trend in these rulings that appear to favor Section 7871(c) financing, these rulings unfortunately do not provide clear guidance. And, the regulation effort based on the 2006 Advanced Notice of Proposed Rule Making (ANPRM) remains stalled. Announcement 2006-59, 2006-2 C.B. 388., REG. 118788-06, 71 Fed. Reg. 45474; ACT 2010 Report, p. 9. Lacking clear guidance, tribal governments will remain reluctant to utilize tax-exempt financing authorized by Code Section 7871(c). And, as mentioned previously, this will result in the TEDB volume cap being used for projects that might otherwise qualify under Code Section 7871(c). Accordingly, the IRS must provide regulatory guidance for Code Section 7871(c).

In addition, ACT encourages the IRS to inform and augment its view of the “commerciality” restriction (under the ANPRM for Code Section 7871(c)) based on the comments of tribes which are incorporated in this report. Tribal governments operate under entirely different conditions and circumstances than state and local governments. Importantly, tribal governments must take on roles that state and local governments can leave to private enterprise. Thus, a traditionally commercial or industrial purpose for state and local governments is not necessarily so for tribal governments. The legislative history to § 7871 does not define the criteria for identifying a commercial or industrial facility, except to state that “commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) . . . [are] not included within the scope of the essential governmental function exception.” H.R. Rep. No. 100-391, at 1139 (1987). As the IRS cited in a recent ruling, “The legislative history of § 7871 indicates Congress was making a distinction between a broader public interest and an interest in profit when it distinguished an essential governmental function from a commercial or industrial activity … we look to all the facts and circumstances to determine whether the ownership and operation of Borrower's interest in

the Project is commercial or industrial in nature for purposes of § 7871(c) and (e)." PLR 200911001. Accordingly, ACT suggests that, in a facts and circumstances test that looks at projects/facilities with a "broader public interest," the unique role of tribes and their special circumstances must be part of the evaluation.

Finally, the ACT recommends that the IRS consider consulting with tribes about Section 7871(c) financing. It may be that the IRS believes tribes have more financing opportunities under Section 7871(c) then are presently being sought. That is not the perception among tribes or the tribal finance community. There remains a fear of enforcement activity by the IRS for financings involving Code Section 7871(c). And, the letter ruling process for determining whether a project qualifies under Section 7871(c) is lengthy, costly and uncertain. Given that consultation is definitely planned to occur as it relates to reallocation of TEDB volume and the utilization of TEDBs, this presents an opportunity to expand the inquiry and consultation to encompass Section 7871(c) so that tax-exempt financing as a whole can be addressed. And, since the regulation project for Section 7871(c) is still pending, this consultation will further the President's Executive Order 13175 to allow timely and meaningful tribal input on regulations and policy matters that have "substantial direct effects on one or more Indian tribes, on the relationship between the federal government and Indian tribes, or on the distribution of power and responsibilities between the federal government and Indian tribes."[11]

[11] Federal Register, Part IV, The President, November 5, 2009-Tribal Consultation.

IV. Conclusion

Tribes deserve at least equal access to the tax-exempt financing vehicles that state and local governments enjoy. There are causes which support an argument for even broader access to tax exempt financing given tribes' unique circumstances and their undeniable unmet economic development needs. Code Section 7871(c) and the custom-based essential governmental function test impede that equal access. And, in fact, it may have a dilatory effect on the progress of TEDBs as a financing vehicle.

TEDBs show promise as a tax-exempt financing vehicle, but there are limitations that are unworkable and should be reconsidered by Congress. And, TEDBs will need more time in the credit markets to become an understood and accepted financing vehicle. In the meanwhile, there are a number of administrative actions that should be taken to facilitate and augment TEDB financing within its current framework.

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Indian Tribal Governments: Survey of Issues Requiring Administrative Guidance in the Wake of Enactment of Section 906 of the Pension Protection Act of 2006

Wendy S. Pearson
Joe Lennihan

June 15, 2011

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I. Executive Summary

This report discusses the administration of the Employee Retirement Income Security Act of 1974, as amended (ERISA) and the Internal Revenue Code of 1986, as amended (Code), respecting employee benefit plans sponsored by Indian tribal governments. In this report, ACT describes issues that will require administrative guidance, or, at a minimum, formulation of policy. The occasion for this report is Congress' enactment of Section 906 of the Pension Protection Act of 2006 (PPA). Section 906 of the PPA amended both the Code and the ERISA to legislatively classify, for the first time, tribally-sponsored employee pension plans as either governmental or commercial plans depending on the nature of the tribal employer's activities. Prior to the enactment of Section 906, the distinction between governmental and commercial employee benefit plans received inconsistent treatment. The distinction between governmental and commercial plans is reasonably well understood outside of Indian country; however, the distinction is not well understood within Indian country.

Section 906 defines governmental plans to include plans established by "an Indian tribal government, a subdivision of an Indian tribal government or an agency of or instrumentality of either, and all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government functions)." Section 906 leaves to the IRS the task of implementing the distinction between governmental plans and commercial plans. Since governmental plans are regulated differently than commercial plans, making the distinction between governmental plans and commercial plans in Indian country will not be easy. Given the sweeping language of Section 906, there is room for disagreement about what tribal activities are governmental and what are commercial. Moreover, there remain many questions about how ERISA applies to tribes whether or not tribal plans are classified as governmental or commercial. Guidance on these questions has been held in abeyance pending resolution of the threshold question which tribal plans are governmental plans and which are commercial plans. Those questions must be answered as well.

The need for administrative guidance in Indian country is significant. A survey conducted in 2004 found that 188 of the 562 federally recognized tribes sponsored some kind of defined contribution plan.[1] Of those plans, 62 were established as governmental plans. The total number of defined contribution plans is likely higher. The total number of all tribally sponsored employee benefit plans issued to date is not known. Correspondents report that tribal employee benefits plans, whether defined benefit plans or defined contribution plans, have not commonly been drafted in ways that account for the unique characteristics of tribal governments. Indian tribes, however, are "unique aggregations

[1] Yoder "Survey of Defined Contribution Retirement Plans For Federally Recognized Indian Tribes" June 9, 2004.

possessing attributes of sovereignty over both their members and their territory" that require special consideration.[2] Tribes share characteristics of both governments and private employers. They are often not subject to federal enactments and are rarely ever subject to state or local law. Few plans adequately address the difference between tribes and governments or private employers.[3] In this report, the ACT surveys the issues requiring special consideration in light of the differences between tribal governments, on the one hand, and other governments and private employers, on the other.

The specific recommendations made by this committee can be summarized, as follows. First, the ACT proposes a federal study be conducted, in consultation with tribes, to inventory and remedy the inconsistent and redundant treatment of tribes caused by the concurrent enforcement and administration of ERISA by the three responsible federal agencies, IRS, DOL and PBGC. This study should also address the matter of retroactive application of ERISA to tribes, as well as the force and authority of tribal law on issues such as Qualified Domestic Relations Orders, trust law, and other areas of conflict between local and tribal law. Second, and perhaps of greatest need, is guidance on the distinction between governmental and commercial plans. The ACT makes several recommendations as to how this distinction may be defined in a way that maximizes tribes' opportunities to sponsor plans that attract employees on at least the same basis as other governments and accords deference to tribal self-government. Third, once a determination is made as to what constitutes a governmental or commercial plan, special rules are warranted for dealing with Section 414 control group and aggregation testing given the unique structure of tribes. Finally, because tribes face imminent deadlines for tribal plan reporting, determination and audit requirements, interim rules allowing for safe harbor reporting and/or extensions are required until the tribes receive guidance from the IRS as to what to report as "commercial" or "governmental."

[2] U.S. v. Mazurie, 419 U.S. 544, 557 (1975).
[3] The ITG received a big assist from ACT's EP work group and others. The ITG group also wishes to thank the law firm Yoder & Langford, P.C.

II. Background

A. ERISA and the Code

1. SUBCHAPTER D OF THE INTERNAL REVENUE CODE

The applicability of the law of employee benefit plans to tribes has never been clear. The statutory framework for employee benefits plans evolved during the course of the 20th century. Amendments to the Revenue Act in 1921, 1926, and 1928 introduced tax advantages for private employment-based retirement plans. Amendments in 1921 to the Revenue Act allowed employers to deduct their contributions to profit-sharing and stock bonus plans from gross income as a business expense.[4] Employees were similarly authorized to defer recognition of income for their contributions to plans until withdrawn, as were investment earnings of plan trusts. The Revenue Act was subsequently expanded to include pension plans. In 1942, Congress amended the Code to impose nondiscriminatory coverage and nondiscrimination in benefits and contributions. In 1954 and again in 1986, the Code was amended and recompiled to articulate this arrangement into Subchapter D of the Code.[5] Currently, Code section 404 allows employers to take a deduction for contributions to a qualified plan[6] in the year of the employer's contribution. Sections 402 and 403 exempt such contributions on behalf of employees participating in a qualified plan from income tax in the year of contribution. Finally, section 401(a) exempts trust investment earnings from income tax.[7]

Neither the Code nor its predecessor Revenue Act makes reference to tribes in the early pension laws or the legislative history. Thus, congressional intention respecting tribes' ability to offer tax qualified employee pension plans is not known. Until the 1980's, there is no evidence in the many amendments to the Code that Congress ever considered whether and how tribes should be treated for purposes of employer-sponsored qualified plans. It is unlikely, however, that tribal employers were in a position to offer profit-sharing or pension plans throughout most of the 20th century. During that period, tribes did not generally engage in labor intensive industries such as manufacturing.

2. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

ERISA was enacted to provide comprehensive regulation of employee benefit plans.[8] Congress found that "despite the enormous growth in such plans many employees with long years of employment are losing anticipated retirement benefits owing to lack of

[4] IRC Sec. 162.
[5] IRC Secs. 401-436, 457; IRC Sec. 501(a).
[6] A "qualified plan" is one which meets the requirements of Section 401(a) of the Code.
[7] See also Code sec. 501
[8] P.L. 93-406, 88 Stat. 832 (1974).

vesting provisions in such plans" and that "owing to the inadequacy of current minimum standards, the soundness of and stability of plans with respect to adequate funds to pay promised benefits may be endangered."[9] Title I of ERISA (Secs. 101-514) covers reporting and disclosure of plan terms, vesting of plan benefits, plan participation, funding and fiduciary standards in administering plans. Title II (Secs. 1001-2008) amends the Code provisions relating to employee benefits plans to regulate participation, vesting and funding issues. Title III (Secs. 3001-3043) covers jurisdictional issues and coordination of enforcement and regulatory activities between the Department of Labor and the Internal Revenue Service. Title IV (Secs. 4001-4082) covers termination of plans and provides federal insurance coverage for defined benefit pension plans.

The administration of ERISA is allocated between the Department of Labor (DOL), the Internal Revenue Service, and the Pension Benefit Guaranty Corporation (PBGC). The DOL has primary responsibility for administering and enforcing Title I. The IRS is responsible for administering and enforcing Title II. The PBGC has primary responsibility for administering and enforcing Title IV. Title III allocates regulatory tasks between the three agencies. Although ERISA allocates regulatory authority between the IRS, DOL and PBGC, there was substantial overlap in executing specific regulatory tasks. The regulatory overlap, however, caused "bureaucratic confusion" resulting in "unnecessarily complex government regulation."[10] The federal government has attempted to resolve the problem of regulatory overlap through several executive reorganizations. As a result of the executive reorganizations, the problem of overlap has been reduced.

Due to the interlocking provisions of ERISA, however, some potential for overlap remains. For the purposes of this report, one concern regarding ERISA overlap is the interpretation of provisions that apply to governmental plans. ERISA and the Code regulate governmental plans differently than commercial plans. Governmental plans are exempt from Titles I and IV. (Title III does not, in general, impose substantive requirements on either governmental or commercial plans). Governmental plans are defined and regulated by both Title I and Title II. Thus, although ERISA assigns responsibility for deciding what plans are governmental plans, the DOL and the IRS independently determine what is a governmental plan.

B. Federal Indian Law

American Indian tribes are unique in the American political landscape. Indian tribes "are neither states, nor part of the federal government, nor subdivisions of either." Tribes have existed as separate political communities since before discovery of the north America by European colonists. The original colonists recognized tribes as distinct political bodies

[9] 29 U.S.C. Sec. 1001.
[10] Message Of the President, Reorganization Plan No. 4 of 1978, E.O. 12108 (August 10, 1978).

and proprietors of aboriginal tribal lands as a tenet of international law. The press of north American colonization reduced the status of tribes through the doctrines of discovery and conquest. Although the federal constitution today vests Congress with plenary authority over tribal governments, the United States continues to recognize tribes as separate sovereigns.

Where Congress does not act, tribes retain their inherent right to "make their own laws and be governed by them."[11] Tribes reserve exclusive authority over intramural matters. A tribe's power to regulate internal affairs includes the power to regulate employment relations within a tribe's territory. In *NLRB v. San Juan Pueblo*, for example, the Tenth Circuit held that the tribe's inherent power of self-government included the right to pass right-to-work legislation governing the conduct of both members and non-members working within the tribe. Tribes also regulate civil affairs over nonmembers who enter into commercial dealings with tribes. Tribes are subject to state laws for their activities outside of Indian country but within the state.

For tribes, the distinction between government and commercial activities is significantly less sharp than in state and local government. Tribal governments act as both "governments" and "proprietors" at the same time. Unlike state or local governments, most property within an Indian reservation is communally-owned. Tribal real property and various assets are held in trust by the United States as trustee for the tribes.[12] Tribal trust property may not be encumbered or conveyed without approval by the tribe and the United States. Use, occupancy and transfer of property by individual members within Indian country are defined by the tribal government. Because tribal property (land, resources, certain tribal funds) is held communally, decisions about allocation of resources are vested in the tribe's government. Decisions about mobilization of tribal capital or other resources are public, not private, decisions.

Tribes do engage in commercial activities. Although tribes act in certain respects like private employers, tribes' tax status does not fully favor treating tribal plans as commercial plans. Tribes are not subject to income tax.[13] Tribal governments therefore do not benefit from the deduction allowed to private employers that sponsor pension plans. Tribal members are subject to income tax on most sources of income. Tribal members and non-members alike are subject to income tax on wage income from employment with tribal governments, with some exceptions. The deduction for employer contributions to qualified plans is therefore beneficial to tribal employees. Nonetheless, if tribes are to become

[11] *Williams v. Lee*, 358 U.S. 217 (1959).
[12] Allotted lands and income from those lands are also held in trust for the benefit of individual tribal members. Some tribal monies are also held in trust by the United States for the benefit of the tribes. *See* Cohen, Handbook of Federal Indian Law, Ch. 15.10 (2005).
[13] Rev. Rul. 67-284. 1967-2 C.B. 55. The IRS administratively determined that tribes are not entities subject to income tax.

economically successful, tribes must be able to recruit and retain workers who have the needed skill sets. Since most employers can offer tax advantaged employee benefits plans, tribes can compete in the labor market only if they can offer equivalent benefits. Treating tribal plans as commercial plans, therefore, imposes on tribes the burden of commercial plan regulation without the full tax benefit afforded private employers.

C. Applicability of Federal Employee Benefits Laws to Tribes

1. JUDICIAL TREATMENT OF TRIBALLY-SPONSORED EMPLOYEE BENEFIT PLANS

Where Congress does not explicitly regulate them, tribes retain their aboriginal right to govern themselves and their territory. The question necessarily arises whether a particular federal enactment that does not explicitly reference tribes should apply to them. The question arises because any federal enactment has the potential to suppress tribal self-government. In some cases, Congress does explicitly reference tribes in legislation. Title VII of the 1964 Civil Rights Act prohibits preferential employment on the basis of race, color, sex, national origin, and religion. Title VII, however, contains an exception that permits Indian preference in employment. Section 703 (I)[14] provides "[n]othing contained in this title shall apply to any business or enterprise on or near an Indian Reservation with regard to any publicly announced employment practices of such business or enterprise under which preferential treatment is given to any individual because he/she is an Indian." In most cases, however, Congress does not explicitly reference tribes in enacting legislation. When Congress does not reference tribes in enacting legislation, courts and administrative agencies must decide whether and how a federal statute might apply to tribes. For most of the nation's history, the presumption has been that federal legislation should be interpreted not to apply to tribes unless Congress so determines.[15] More recently, federal courts have shown a willingness to presume that federal enactments do apply to tribes. In *Federal Power Commission v. Tuscarora Indian Nation*, decided in 1960, the Supreme Court held that the Federal Power Act did apply to tribes' property interests.[16] In *Tuscarora,* the Court ruled that the Act authorized federal condemnation of tribal fee land for a power plant. Although the Act explicitly referenced tribal property interests, the Court observed that "it is now well settled by many decisions of this Court that a general statute in terms applying to all persons includes Indians and their property interests."

Because of the ambiguity in *Tuscarora*, federal courts have limited the literal language of *Tuscarora's* dictum. Federal courts have limited *Tuscarora's* applicability to those federal statutes that do not unnecessarily infringe upon tribes' reserved "exclusive rights of self-government in purely intramural matters" or that would abridge treaty

[14] 42 U.S.C. 2000 e-l(i).
[15] See, e.g., *Elk v. Wilkins*, 112 U.S. 94 (1884).
[16] 362 U.S. 584, 80 S.Ct. 543, 4 L.Ed.2d 584 (1960)

guaranteed rights. The question whether a federal enactment would abridge a tribal treaty right requires examination of the particular treaty. On the issue of treaty abrogation, no general rule respecting the applicability of a federal statute is possible, since the terms of treaties between the United States and different tribes vary from tribe to tribe.

The question whether a general federal enactment would "infringe" on tribal self-government produces different results. In *EEOC v. Fond Du Lac Heavy Machinery*,[17] for example, the Eighth Circuit Court of Appeals found that tribal employment relations were "intramural matters." The Equal Employment Opportunity Commission (EEOC) brought a discrimination claim under the Age Discrimination in Employment Act (ADEA), against Fond du Lac Heavy Equipment and Construction Company. The issue was whether the company had discriminated against a tribal member. The tribe owned the company, which was located on the reservation. The company performed services both on and off the reservation. The Eighth Circuit distinguished *Tuscarora*, noting that *Tuscarora* "does not apply when the interest sought to be affected is a specific right reserved to the Indians." The Eighth Circuit concluded that application of the ADEA in this case would infringe on intramural tribal affairs. The court reasoned that "consideration of a tribal member's age by a tribal employer should be allowed to be restricted (or not restricted) by the tribe in accordance with its culture and traditions."

Not surprisingly, even the interpretation of a specific congressional enactment can produce different results. The Ninth and Tenth Circuit Courts of Appeal have split on the question whether OSHA applies to tribes. In *Donovan v. Navajo Forest Products Industries*,[18] the Tenth Circuit, held that the Treaty of 1868, which reserved to the Navajo Nation the right to exclude nonmembers, including federal agents, from passing through the reservation without tribal consent precluded the enforcement of OSHA against a Navajo lumber mill. The Secretary of Labor issued citations against the tribe alleging OSHA violations at the mill. The Tenth Circuit found that employees moved mill products both within and outside of the reservation.[19] The court concluded that "the Navajos have not voluntarily relinquished the power granted under Article II of the treaty. Neither has that power been divested by congressional enactment of OSHA; to so imply would be to dilute the recognized attributes of Indian tribal sovereignty over both their members and their territory."[20]

In contrast, in *USDOL v. OSHA Health & Safety Bd*.[21], also involving a tribal lumber mill, the Ninth Circuit held that the tribe was subject to OSHA. As in *Navajo Forest Products*, the Secretary of Labor issued citations alleging OSHA violations. The

[17] 986 F. 2d 246 (8th Cir. 1993)
[18] 692 F. 2d 709 (10th Cir. 1985).
[19] 692 F. 2d at 711.
[20] *Id.*
[21] 935 F. 2d 182 (9th Cir. 1991)

Confederated Tribes of Warm Springs owned and operated the mill and the mill employed both tribal members and non-members. Tribal timber supplied the mill but end products were sold almost entirely off-reservation. A treaty entered into between the confederated tribes and the United States provided, "[a]ll of which [reservation lands] shall be set apart, and, so far as necessary, surveyed and marked out for their exclusive use; nor shall any white person be permitted to reside upon the same without the concurrent permission of the agent and superintendent." Acknowledging that the tribe had reserved its right to exclude non-members in the treaty, the Ninth Circuit nonetheless held that "we do not find the conflict between the Tribe's right of general exclusion and the limited entry necessary to enforce the Occupational Safety and Health Act to be sufficient to bar application of the Act to the Warm Springs mill. The conflict must be more direct to bar the enforcement of statutes of general applicability. Were we to construe the Treaty right of exclusion broadly to bar application of the Act, the enforcement of nearly all generally applicable federal laws would be nullified, thereby effectively rendering the Tuscarora rule inapplicable to any Tribe which has signed a Treaty containing a general exclusion provision."

No federal circuit has held that ERISA does not apply to tribal employers. The Seventh and Ninth Circuits have each held that ERISA does apply to tribal employers. In *Smart v. State Farm Insurance*,[22] a tribal member filed suit over the denial of health benefits under a tribally-sponsored health plan. The tribe contracted with State Farm Insurance Company for a group health plan. The health plan covered employees of a health care center owned and operated by the tribe. The tribe asserted that application of ERISA to the dispute would infringe on the tribe's right to determine employment relations between the tribe and tribal members. The Seventh Circuit held that while the application of ERISA to plaintiffs claims might "affect" tribal self-governance, it did not directly "threaten" tribal self-governance, since the tribe had contracted with State Farm. The Seventh Circuit reasoned that the dispute did not "threaten" tribal self-governance because the dispute was, in effect, a dispute between the employee and the tribe's chosen insurer.

In *Lumber Industry Pension Fund v. Warm Springs Forest Products Industries*,[23] the Ninth Circuit likewise held that ERISA applied to a tribal enterprise that operated a reservation sawmill. Upon purchasing the sawmill, the tribe assumed the obligations to make contributions to the pension fund pursuant to a collective bargaining agreement. The tribe subsequently passed a law establishing a tribally-sponsored pension plan and the enterprise began paying into the tribe's fund. In a brief opinion, the Ninth Circuit held that enforcing ERISA in these circumstances would not "usurp the tribe's decision making power." The Ninth Circuit reasoned that tribe could form its own plan or transfer employees to the new plan at the end of the term of the collective bargaining agreement.

[22] 868 F. 2d 929 (7th Cir. 1989).
[23] 939 F. 2d 683 (9th Cir. 1991).

Both decisions have been the subject of criticism. In a subsequent decision, the Seventh Circuit criticized what the court referred to as dictum in *Smart* that federalism uniquely concerns States and that there is no tribal counterpart. The Seventh Circuit stated this "dictum" had gone too far:

> Comity argues for allowing the Indians to manage their own police as they like, even though no treaty confers such prerogatives, until and unless Congress gives a stronger indication than it has here that it wants to intrude on the sovereign functions of tribal government.[24]

Commentators have also questioned the Seventh and Ninth Circuits' reasoning in ERISA cases.[25]

Uncertainty about the applicability of federal enactments to tribes shows that the longstanding policies underlying federal Indian law collide with specific federal enactments in unpredictable ways. In an earlier report, the ACT noted that decisions about the applicability of federal enactments to tribes in the absence of any expression of congressional intent often create intractable administrative difficulties.[26] ERISA is no exception. If ERISA applies, then many questions arise how to interpret ERISA and the Code to apply to tribes. For tribes, the most important interpretive question in ERISA has been whether tribal plans were governmental plans or commercial plans. Both ERISA and the Code define a governmental plan as any plan "established and maintained for its employees by the Government of the United States, by a government of any state or political subdivisions thereof, or by any agency or instrumentality of any of the forgoing." Significantly, governmental plans are not defined by the nature of the employment activity of the participants who are covered by the plan. ERISA makes a distinction between governmental plans and private or commercial plans. Governmental plans are exempt

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[24] *Reich v. Great Lakes Indian Fish & Wildlife Commission*, 4 F.3d 490, 495 (7th Cir.1993)

[25] See Limas, "Application of Federal Labor And Employment Statutes To Native American Tribes: Respecting Sovereignty And Achieving Consistency" 26 Ariz. St. L. J. 681, 698 (1994)("A primary flaw in the reasoning of the Seventh and Ninth Circuit OSHA and ERISA cases, as well as that of the ADEA dissent, is that the reasoning fails to distinguish tribally owned business from private sector-sector business (this reasoning is also apparent in the FLSA case). In failing to make that distinction, courts ignore federal law and policy favoring tribal sovereignty and incorrectly determine that no sovereign rights are being affected by application of the statute in question. Such reasoning ignores the fact that the operation of a business by a tribe is a critical aspect of that tribe's sovereignty, allowing the courts to sidestep the first exception to the "Tuscarora rule": that Congress must "expressly" state that a statue applies to a tribe if the statute "touches upon 'exclusive rights of self-governance in purely intramural matters.'"); ; Burge, "ERISA and Indian Tribes: Alternative Approaches For Respecting Tribal Sovereignty," 2000 Wisc. L. R. 1291, 1309 (2000) ("In *Smart*, the Seventh Circuit would have considered congressional intent only if the Tribe could have proven that its situation fell under one of the exceptions. Ironically, at the beginning of its opinion, the court itself proclaimed that '[c]ongressional intent is paramount in determining the applicability of a [federal] statute to Indian tribes', but nevertheless, it assumed that ERISA applied to the Tribe without examining congressional intent."; Conrad, "The 9th Circuit Approach to Applying Federal Labor and Employment Law to Indian Tribes" Washington State Bar Association Bar News (November 2002)("it has become clear that the 9th Circuit is unwilling to extend the notions of tribal sovereignty to tribal commercial enterprises").

[26] 2010 ACT Report, "FICA Taxes In Indian Country And The Problem Of Selective Incorporation In Administration Of The Code" (June 9, 2010).

from Title I and IV. Title II generally applies to governmental plans but supplies partial exemptions to governmental plans. In some cases, such as with the minimum distribution or discrimination rules, the Code applies in a different way.[27] In contrast, all three titles of ERISA apply to commercial plans.

Courts and federal administrative agencies have reached different results in determining whether tribally-sponsored plans should be treated as governmental or commercial plans. In PBGC Opinion 81-3, the PBGC considered whether a tribally-sponsored plan was a governmental plan for purposes of Title IV. The employer organization was composed of elected tribal officials selected from different tribes. The organization distributed funds from various other governments and non-profits to member tribes. The PBGC concluded that the tribes were acting together as sovereigns and that the authority to define the Council's relationship with its employees "is undoubtedly an attribute of the Tribes' sovereignty." On the other hand, in Opinion 89-9, PBGC administratively opined that a tribal plan for employees of a tribal factory was a private plan for purposes of Title IV. The factory was located off-reservation and employed mostly non-Indians. The factory sold its products to non-Indians. The PBGC concluded that the tribal plan was not a governmental plan. The PBGC distinguished Opinion 81-3 on the ground that the activities in the Opinion "were characteristically governmental, non-profit activities focused within the reservation" whereas the factory served "to make a profit" for the tribe.

In *Colville Confederated Tribes v. Somday* is one of the very few court cases to consider the classification of tribes for purposes of ERISA. The district court for the eastern district of Washington considered whether a tribal plan was a governmental plan or commercial plan. The plan at issue covered tribal governmental employees. Due to a local economic downturn, the tribe reduced plan benefits. A tribal member challenged the reduction of benefits on the grounds that the tribe had not received federal approval. If the Colville plan was a governmental plan, then the tribe could reduce plan benefits without federal approval.[28] The district court deferred to a PBGC administrative determination that the Colville plan was a governmental plan. PBGC had opined that "the pension plan is a plan strictly for employees of the tribe. The tribe has the power to levy taxes as an aspect of its retained sovereignty which would allow the tribe the taxing authority to make up any funding deficit incurred by the pension plan." In ruling for the tribe, the court held that the PBGC interpretation of the tribe's status was reasonable.

The IRS does not issue determination letters or rulings on the question whether a tribal plan is a governmental plan. Since 2004, there has been a "no-rule" position foreclosing tribes' ability to seek confirmation whether tribally-sponsored plans were

[27] IRC Sec. 401(m); IRC Sec. 401(a)(9).
[28] 29 USC Sec. 1054(g)(1).

governmental plans.[29] It has been reported that the PBGC has rejected Form 5500 filings on the ground that tribal plans are governmental plans.[30]

2. CONGRESSIONAL TREATMENT OF TRIBALLY-SPONSORED EMPLOYEE BENEFIT PLANS

Congress has enacted special rules relating to tribal employee benefit plans. In several cases, it appears that Congress has acted legislatively to "ratify" plans previously adopted by tribal employers without expressing a preference whether tribes be treated as governmental plans or commercial plans or something else. The first expression of congressional preference was enactment of the 1982 Indian Tribal Governmental Tax Status Act. The Indian Tribal Governmental Tax Status Act allowed: a deduction from federal income tax for taxes paid to an Indian tribe; a deduction for charitable contributions to tribal governments; an exemption for tribal governments from various federal excise taxes; and an exemption from tax on interest of certain tribal governmental debt obligations. The Act also specifically authorizes tribes to sponsor 403(b) plans. The legislative history of the Act sheds few clues on the question how Congress intended tribes to be treated for purposes of qualified employee benefit plans. The fact that Congress believed that it was necessary to legislatively authorize 403(b) plans suggests Congress was uncertain about the applicability of pension laws to tribal governments. If ERISA and the Code applied, then there would not seem to have been a need for specific authorization for 403(b) plans. On the subsidiary question of classification of tribally-sponsored plans, the Act sheds no light on Congressional understanding whether tribal plans should be treated as governmental plans or commercial plans. It is difficult to imply a congressional preference because 403(b) plans may be sponsored by either tax-exempt or governmental entities.[31]

Congress subsequently enacted the Small Business Jobs Protection Act of 1996, which amended Section 401(k)(B) of the Code to allow tribal governmental employers to sponsor 401(k) plans. Because state and local governmental employers are ineligible to sponsor 401(k) plans, the 1996 Act amended Section 401 of the Code to provide "[a]n employer which is a tribal government... may include a qualified cash or deferred arrangement as part of a plan maintained by the employer." It has been reported that many tribal employers had set up 401(k) plans for tribal employees based on the assumption that tribal plans were not governmental plans. The legislative history shows that Congress was aware of the uncertainty about whether tribal employee benefit plans should be treated as governmental plans or commercial plans. The Senate Report and the Conference Report

[29] Rev. Proc. 2004-4, 2004-1 C.B. 125 (2004).
[30] Calhoun & Moore, "Governmental Plans Answer Book", p. 1-5 (2002)("it is the authors' understanding that the PBGC has routinely returned Form 5500 filings by plans of Native American tribes(regardless of whether the plans covered employees engaged in business or governmental functions) on the theory that they are not required because the plans are governmental plans ").
[31] Correspondents report that some tribal employers across the country were improperly sold 403(b) tax sheltered annuity programs largely because there was a lack of guidance regarding what tribal employers could or could not do. Some Section 403(b) program compliance issues remain unresolved.

both explain that "no inference is intended with respect to whether Indian tribal governments are permitted to maintain qualified cash or deferred arrangements under present law." The congressional reference can be read in alternative ways. Congress' reference might be read to mean that pre-existing tribally-sponsored 401(k) plans were not illegal under prior law. Alternatively, the congressional reference might be read to prohibit the broader inference that other tribally sponsored government plans could no longer be treated as government plans. Both interpretations are plausible.

Beginning in 2003, there were several efforts to amend ERISA to identify tribal plans as either governmental plans or commercial plans. The Governmental Pension Plan Equalization Act was introduced to "clarify" that a tribally sponsored plan would be treated as governmental plans. The bill made the clarification retroactive, providing that the bill would be effective for "years beginning before, on, or after the date of this enactment." It is reported that at least one aim of the bill was to address uncertainty about whether tribes could sponsor 457(b) arrangements. States and local governments or organizations exempt from tax are eligible to establish 457(b) arrangements. Commercial employers, on the other hand, are not eligible to sponsor 457(b) arrangements.[32]

3. THE PENSION PROTECTION ACT OF 2006

The legislative efforts, which began in 2003, culminated in the enactment of Section 906 of the Pension Protection Act (PPA). Section 906 amended Section 414(d) of the Code and Section 3(32) of ERISA to include, as a governmental plan, any pension plan which is "established and maintained by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government." Section 906 added an important qualification that a subdivision of an Indian tribal government is, "determined in accordance with section 7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential governmental function)." Section 906 made similar amendments to the definition of "governmental plan" in Section 4021(b) of ERISA. Minor amendments were also made to Sections 415(b)(2), 415(b)(10) and 414(h)(2) of the Code.

The PPA moved swiftly through Congress. The bill was introduced July 28, 2006, and signed by President Bush on August 17, 2006. There is little legislative history on the scope of Section 906. The congressional record does not disclose any tribal testimony on the scope or timing of Section 906. The Joint Committee on Taxation offered its post-passage view that a tribal governmental plan would include a plan in which "all of the

[32] See Bonnett, "Applicability of ERISA to Indian Tribes (A Law in No Need of Clarification)" 30 J. Pension Plan & Compliance 55 (Fall 2004)(arguing that tribes are not governments for purposes of 457(b)).

participants are teachers in tribal schools." A tribal commercial plan, by contrast, would, according to the Committee, include a plan covering "tribal employees who are employed by a hotel, casino, service station, convenience store, or marina."

The National Congress of American Indians (NCAI) opposed the enactment of Section 906. In a resolution adopted in October 2006, the NCAI asserted that Section 906 "unfairly singles out Indian tribal governments for disparate treatment by dividing Indian tribal employees into governmental and commercial categories, while state and local governments are not required to make distinctions so that state lottery employees, ABC liquor store employees, and others are free to enjoy the same plan benefits as other state employees." The NCAI objected to Section 906 for the additional reason that splitting plans "places undue and cost and administrative burdens on Indian tribal governments."

Section 906 became effective on January 1, 2007, and by its stated terms, applied to plan years beginning after the effective date of the Act. Many tribes that sponsored employee plans were put in the position of amending their plans immediately to create a second plan for commercial employees. In response, the Service issued Notice 2006-89. Notice 2006-89 provides transitional relief to tribes provided tribes operate their plans in a "reasonable and good faith manner." Operating a plan in a reasonable and good manner is presumed if the tribe: a) adopts a separate ERISA compliant plan covering commercial employees; b) the tribe freezes plan benefits accruals under its governmental plan for commercial employees; and c) the tribe does not reduce benefits in the continuing commercial plans (with exceptions). Tribes were required to effect these changes by September 30, 2007, for plan years beginning after the effective date of the Act. In August 2007, the Service extended the transitional relief afforded by Notice 2006-89 until a date six months after the Service issues guidance under Code Section 414(d) as amended by Section 906. The Notice warns that plans should not be amended to reduce benefits in a way that disadvantages commercial plan participants until further guidance.

That guidance has not been issued to date.

4. POST PPA DEVELOPMENTS

a. Retroactivity

Federal courts have recently considered the question whether Section 906 applies retroactively or prospectively only. In *Dobbs v. Anthem Blue Cross and Blue Shield*,[33] the Tenth Circuit held that Section 906 applied retroactively. The *Dobbs* Plaintiff was a tribal member who sued the tribes' insurer for failure to honor the terms of the tribes' employee

[33] 600 F. 3d 1275 (10th Cir. 2010); *but see, Geroux v. Assurant*, 2010 WL 1032648 (W. D. Mich.)(Section 906 applies prospectively).

benefit plan. Plaintiff's claims arose prior to enactment of the PPA. Except for claims brought by a participant under ERISA section 502(a)(1)(B) to recover benefits or enforce his rights under a plan, federal courts have exclusive jurisdiction to hear ERISA claims -- unless the plan is a governmental plan. The Colorado federal district court concluded that that the tribally-sponsored plan was not a governmental plan and the parties appealed. During the course of appeal from the district court's decision, Section 906 was enacted. If Section 906 applied prospectively only, then ERISA would apply to plaintiff's claims. If Section 906 applied retrospectively, then ERISA would not apply to plaintiff's claims. The *Dobbs* Court held that Section 906 applied retrospectively to bar removal of an ERISA claim to federal court. The Court concluded that Section 906(b) recites that it is intended to be a "clarification" of existing law. The Congressional Record described Section 906 as a bill to amend the Code and ERISA "to clarify that federally recognized Indian tribal governments are to be regulated under the same government employer rules and procedures that apply to federal, state, and other local governments employers." The Court concluded that this language sufficiently evidenced Congressional intent that Section 906 apply retrospectively.

b. Treatment as "A State" Versus "A Government"

This year, the DOL issued Opinion 2011-03A on the question whether a plan trustee could honor a tribal court domestic relations order without violating the anti-assignment provisions of Title I. The Opinion was given in response to an inquiry by a New Mexico private employer, some of whose employees were tribal members. Under Section 206 (d)(1) of ERISA plan benefits may be assigned only in accordance with a qualified domestic relations order.[34] A qualified domestic relations order is defined as a "a judgment or decree or order that relates to the provision of child support, alimony payments or marital property rights to a spouse... pursuant to state domestic relations law." In Opinion 2011-03A, the DOL interpreted this provision to prohibit plan administrators from giving effect to tribal court orders relating to domestic relations. The DOL concluded that although Section 906 attempted to afford tribes treatment as governments, Section 906 did not amend the provisions specifically relating to qualified domestic relations orders, and that tribes could not be treated as state governments for purposes of the anti-assignment provisions of ERISA.

[34] 29 USC 1056(d)(3)(ii).

III. Issues Requiring Administrative Guidance

The sections that follow outline issues that may require administrative guidance. Enactment of Section 906 of the PPA clarified that tribally-sponsored plans can be either governmental plans or commercial plans. Enactment of Section 906 is the clearest expression yet that Congress intends that the Code and ERISA should apply to tribes in full when tribes sponsor a plan covering employees of tribal commercial activities. The enactment of Section 906 therefore forces tribes and federal administrators to focus in detail on how ERISA and the Subchapter D of the Code apply to tribal employers. The issues requiring formal guidance, or at least internal discussion within the IRS, fall into two categories. The first category of issues requiring guidance concerns broad questions regarding applicability of ERISA and the Code, regulatory conflicts and the role of local law. The second category of issues requiring guidance concerns specific mechanics of compliance with provisions of ERISA and the Code.

A. Broad Issues Requiring Guidance

1. OVERLAPPING REGULATORY JURISDICTION CREATES CONFUSION AND CONFLICT

Labor Opinion 2011-03A raises several questions. Questions raised by Opinion 2011-03 include questions about *who* and *in what circumstances* tribes will be treated as governments or states for purposes of the Code and ERISA. At least three federal agencies are tasked with interpreting ERISA. The IRS, DOL, and the PBGC all must interpret ERISA, promulgate regulations, and take enforcement action. Judicial review of those administrative interpretations is limited because federal courts accord deference to the agency decisions.[35] The comprehensive scope of ERISA, however, leaves room for different interpretations of ERISA or the Code.[36] In some cases, ERISA imposes functionally equivalent requirements on the different agencies. Part 4 of Title I, for example, imposes statutory fiduciary standards on persons who have discretion over administration of the plan, investment of plan assets or persons who provide investment advice for a fee.[37] Although governmental plans are exempt from the specific fiduciary requirements imposed on private employers under ERISA, Section 401(a)'s exclusive benefit requirement has been interpreted to impose equivalent fiduciary standards on government plans so that, in effect, the Code imposes on governmental plans similar

[35] *Somday* 96 F. Supp. 2d at 1136 ("PBGC interpretations are afforded 'great deference' by courts").
[36] *Somday* at 1128 (dispute between litigants as to whether court should defer to PBGC opinion or await DOL interpretation of disputed provisions); (Message Of the President, Reorganization Plan No. 4 of 1978, E.O. 12108 (August 10, 1978) ("the Departments of Treasury and Labor both have authority to issue regulations and decisions. This dual jurisdiction has delayed a good many important rulings and, more importantly, produced bureaucratic runarounds and burdensome reporting requirements").
[37] See ERISA, Section 3(21).

fiduciary rules that apply to private plans.[38] In most cases, however, governmental plans are subject to statutory fiduciary standards imposed by their state or local laws.

Opinion 2011-03A presents interpretive issues common to both the IRS and the DOL. The Opinion analyzes the interplay of ERISA section 206 and Code section 401(a)(13). Section 206 prohibits the assignment of plan benefits except in response to qualified domestic relations orders. Qualified domestic relations orders are as defined in Section 206(d)(3)(ii) as a "judgment, decree, or order (including approval of a property settlement agreement) which relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, and is made pursuant to a state domestic relations law (including a community property law)." Like section 206(d), section 401(a)(13) of the Code prohibits assignments of plan benefits.[39] Code sections 401(a)(13) and 414(p) except from the general anti-assignment rule assignments made pursuant to qualified domestic relations orders.[40] Like section 206(d) of ERISA, section 414(p) of the Code defines domestic relations orders as orders made "pursuant to State domestic relations law."[41] The IRS has not issued guidance whether a tribal domestic relations order should be treated as a qualified domestic relations order for purposes of Section 414.

Opinion 2011-03A illustrates the problem of conflicting interpretations. Either the IRS follows the DOL determination in interpreting section 414(p) or the IRS independently interprets section 414(p) to include tribal domestic relations orders as qualified domestic relations orders. Either interpretation poses problems for tribes. If the IRS interprets section 414(p) to include qualified tribal domestic relations orders as qualified domestic relations orders, then Indian tribes are subject to conflicting interpretations between different agencies on the same issue. Since each agency has the authority to interpret or police this issue, tribes would find themselves caught between conflicting commands of different federal agencies. In addition to being inherently undesirable, inconsistent treatment is likely not what Congress intended.

If, alternatively, the IRS interprets section 414(p) to exclude qualified tribal domestic relations orders, then tribes will be caught in a different conflict. State courts lack jurisdiction over matters involving tribal members. Federal law holds that tribal courts are the proper arbiters of tribal member disputes. This protective rule applies with particular force in tribal domestic relations matters. Even where tribal members agree, the Supreme

[38] IRC 401(a)(2).
[39] IRC 401(a)(13)(a).
[40] IRC 401(a)(13)(B); IRC 414(p)(1)(B).
[41] IRC 414(p)(1)(B).

Court has held state courts lack authority to adjudicate tribal domestic disputes.[42] Thus, interpreting section 414(p) the same as ERISA section 206(d) would require tribal members to proceed in a forum without jurisdiction to act. A determination that tribal domestic relations orders do not qualify would conflict with federal law holding that tribal court domestic relations orders are the only valid source of domestic relations orders. This result also seems doubtful.

Recommendation

The Committee recommends that the IRS undertake a study of the provisions in which tribes are exposed to inconsistent treatment between the administering agencies. The study should be coordinated with the Department of Labor and the PBGC. Executive Order 13175 mandates that all executive branch agencies consult with tribes when formulating and implementing policies that have a substantial direct effect on tribes. Section 3(b) provides that the federal government shall grant Indian tribal governments the maximum administrative discretion possible. Section 5(c) provides that, to the extent practicable and permitted by law, no agency shall promulgate any regulation that has tribal implications and preempts tribal law unless the agency, prior to the formal promulgation of the regulation consults with tribal officers.

All three agencies operate under the Executive Order 13175. Each agency could take an important step toward satisfying its mandate by undertaking to inventory the possibilities for inconsistent or redundant treatment of tribes. Due to its complexity and breadth, ERISA has significant potential to interfere with tribal sovereignty. The three agencies might first meet among themselves to inventory possible areas of likely conflict. After making an inventory, the agencies could issue a notice to tribes and solicit comments on resolution of identified conflicts and seek input on any additional sources of conflict. Such consultation should occur early in the process of developing the proposed regulation and should provide a mechanism for tribes and Treasury to reconcile regulations or other guidance with tribal laws. When conflicting commands cannot be reconciled, then the agencies should coordinate in formulating a policy that provides a mechanism for tribes to seek waivers or other reasonable accommodation. The ACT would hope that guidance would be tailored to preserve tribal self-government.

[42] *Fisher v. District Court*, 424 U.S. 382 (1976)("since the adoption proceeding is appropriately characterized as litigation arising on the Indian reservation, the jurisdiction of the Tribal Court is exclusive"); *see also Williams v. Lee,* 358 U.S. 217 (1958)(exclusive tribal court jurisdiction over commercial dispute).

2. CONFLICT AND UNCERTAINTY REGARDING APPLICABILITY OF LOCAL LAW TO PENSION PLANS

Some aspects of employee benefits plans are determined by reference to local law. The Code, for example, determines whether the plan and trust qualify under sections 401(a) and 501(a). State or local law determines whether there is a valid trust for purposes of the Code. There is no formal guidance whether a trust established pursuant to tribal law would qualify as a valid trust for purposes of the Code. Likewise, Section 415(m) of the Code, relating to excess benefit arrangements of governmental entities, requires that creditors be able to attach trust assets. A question arises whether a requirement that a secured creditor proceed in tribal court or under tribal laws would satisfy section 415(m). In many cases, tribal laws regarding creditor remedies are less developed, or applied differently, than state or local laws. Similarly, Section 503(b), applicable to tax-exempt entities and governmental entities, prohibits certain transactions between trusts and others. Section 503(b)(3) prohibits making certain services available on a preferential basis. Many tribes, however, have enacted laws according employment or business preferences for tribal employees and businesses. Tribal preferences are valid exercises of tribal authority.[43] A similar question arises whether tribal preference laws would conflict with Section 503(b)(3) and, if so, how the conflict should be resolved.

A subsidiary question arises concerning the role of tribal courts in determining questions of local law. Tribal courts do not employ the same judicial procedures that state or local courts may employ. Nonetheless, Congress and the courts have adopted a policy of deferring to tribal courts on tribal matters.[44] The question whether tribal courts have jurisdiction to decide issues of local law as they relate to interpretation or administration of ERISA and the Code should be considered. The ACT suggests that tribal courts should be accorded the same role as state or local courts in deciding issues respecting the administration of ERISA.

3. RETROACTIVITY

The *Dobbs* decision raises the question whether ERISA will apply to tribes retroactively. The *Dobbs* decision supplies the decisional rule for the Tenth Circuit. The geographic jurisdiction of the Tenth Circuit covers a significant number of tribes in the western United States. For those tribes, the IRS will need to consider, even if only internally, what other consequences might flow from retroactive application of Section 906. Moreover, the question of retroactivity may have different consequences for DOL and

[43] *Morton v. Mancari*, 417 U.S. 535 (1974). For an example of a tribal business preference law, see 5 N.N.C. Chap. 2 (Navajo Nation business preference law); see also Cohen, Handbook of Federal Indian Law (2005), Sect. 21.02[5].
[44] See *Iowa Mutual v. LaPlante*, 480 U.S. 9 (1987)(tribal courts have exclusive jurisdiction over local law; federal courts defer to tribal court on questions of federal law subject to federal judicial review).

PBGC than for the IRS. The three agencies should jointly consider the question of retroactivity specifically as it relates to their respective regulatory responsibilities towards tribes.

4. GUIDANCE ON THE DISTINCTION BETWEEN TRIBAL GOVERNMENTAL PLANS AND COMMERCIAL PLANS

There is little question that the primary issue for substantive guidance is defining governmental and commercial plans. Most other issues requiring administrative guidance will be helpful only after guidance is issued on the issue of which tribal plans fall into which classification. The distinction between commercial and governmental plans will be difficult. There is no clear congressional expression of intent regarding the activities that should be treated as governmental or commercial. The distinction did not appear in any of the House or Senate versions of the tribal pension reform bills.[45] The distinction between governmental and commercial appears only in the final draft under consideration by the conference committee. The conference committee did not complete its review before the vote was taken, and a final conference report was not published.

The ACT suggests that there are three approaches to distinguishing between commercial and governmental plans. First, the distinction between tribal commercial and governmental activities could be defined by the decisional rules that distinguish between commercial and governmental for state and local governments. Second, the distinction between tribal commercial and governmental activities could be defined by reference to pre-enactment legal precedent. Third, the distinction between tribal commercial and governmental activities could be defined by reference to the rules employed in Section 7871 of the Code.[46]

First approach

Under the first approach, the IRS would interpret the distinction between governmental and commercial in the same way as other governments. State and local governments often sponsor activities that appear to be commercial. Those activities are nonetheless treated as governmental because the activities are carried out by the government and funds generated by the activities benefit the public. Correspondents report that from 2000 through 2004, state municipalities issued almost $61 billion in tax-exempt bonds for “park and recreation facilities” including theaters, stadiums and arenas.[47]

[45] See, for example, S 673 (introduced March 17, 2005) and HR 331 (introduced January 25, 2005).
[46] See ACT Report 2010 “Indian Tribal Governments: The Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009” (June 9, 2010), (“ACT 2010 Report”) pp. 7-10 (discussing the “essential governmental function” test for purposes of Section 7871).
[47] Joint Comments of the Profit Sharing/401k Council of America and Yoder & Langford, P.C., to Notice 2006-89, (Jan. 22, 2007).

State and local governments financed 2,400 municipal golf courses in 2005. Many of those government-financed courses included "resorts or real estate developments." Similarly, state and local governments regularly engage in what can only be described as "commercial" ventures to raise funds for public purposes. Additional examples include lumber purchases from the state of Washington, sales of "Big Pick" lottery tickets in Arizona, and liquor purchases from the city owned liquor stores in Minnesota, Pennsylvania, and Delaware. Under the first approach, the IRS would define tribal activities in the same manner as it defines those activities for other governments. Such an approach would recognize that the definition of a tribally-sponsored commercial plan would have a very narrow scope. The first approach accords tribes the same treatment as other governmental employers for purposes of ERISA. The first approach, however, also significantly discounts the distinction between governmental and commercial plans set forth in the text of Section 906.

Second approach

Under the first approach, the IRS would interpret the distinction between governmental and commercial by reference to prior precedent. The second approach accounts for the distinction in the text of Section 906 between governmental and proprietary and also accounts for the possibility that Section 906 applies retroactively. At the time that section 906 was enacted, there were judicial and administrative precedents on the question whether tribal plans should be treated as governmental or commercial plans. Those precedents indicate that tribal plans would be categorized based upon: (1) whether the plan covered predominantly tribal employees; (2) whether the covered employees' activities were on or off-reservation; and (3) whether the activity was similar to the activities of a "non-profit" or "for profit" organization. The "for profit" versus "non profit" distinction is analogous to the "governmental" versus "proprietary" distinction that has governed state immunity from federal regulation and state law tort immunity.[48] There exists a body of precedent defining which activities are governmental and which are proprietary. The body of precedent, however, is not well suited to serve as a source of guidance because the many cases that distinguish between governmental functions and commercial functions cases are very difficult to reconcile.

Third approach

The third approach would analyze the administrative interpretations of IRC 7871. Section 7871(c) authorizes tribal governments to issue tax-exempt bonds in certain circumstances. The Section employs a distinction between commercial and governmental activities. The Conference Committee report on Section 906 suggests that the conference

[48] *South Carolina v. United States*, 199 U.S. 437 (1905)(federal law of immunity); 57 Am Jur "Municipal, County, School and State Tort Liability", Secs. 57 and 58 (providing examples of state law governmental immunity).

committee was of the view that the distinction between commercial and governmental is analogous to Section 7871(c). Then third approach is consistent with Section 906 and is supported by the Joint Committee. The third approach, however, accords tribes significantly different, and less desirable, treatment than other governments for purposes of ERISA. The distinction between governmental and commercial for purposes of Section 7871 has been the subject of much criticism.[49]

Recommendation

There are several reasonable interpretations of Section 906. The IRS should adopt an interpretation of Section 906 that affords tribes the same opportunity to sponsor plans that attract employees on the same basis as other governments and accords deference to tribal self-government.

5. CONTROL GROUP ISSUES

Once the IRS determines which plans will be treated as commercial plans and which will be treated as governmental plans, plan sponsors will need to know how various separate commercial entities within the tribal government should be treated for testing purposes under the Sections 414(b) and (c).[50] Control group testing causes persistent disagreement between private plan administrators and the IRS. These disagreements are made significantly more difficult for tribes. Because tribes do not resemble corporations or the other forms of business associations commonly employed by private employers, the control group issues are correspondingly more difficult for tribes when they act as "commercial" enterprises.

(a) Guidance should clarify whether controlled group tests apply.

Section 414 defines controlled groups, common control and affiliated service groups with reference to corporate shared ownership and profits interests. These testing statutes do not fully account for governmental plans. There is no indication in the legislative history expressing intent to apply those requirements to tribal government entities. There are significant differences in tribal governmental structures. Some tribes are "treaty" governed tribes. Others have "BIA form constitutions" and charters. Still others have constitutions very similar to state or federal constitutions. One feature common to tribes is that most tribally-owned entities do not issue stock. Most are structured under tribal charters, through tribal resolution, through tribal ordinance, through tribal non-stock corporate codes, or through federal Section 17 corporate charters. There is little barrier between the government and subordinate enterprise. Control remains vested in either the elected

[49] ACT 2010 Report, pp. 9-11; Tribal Advice and Guidance Policy Advisory Committee on Tax Exempt and Government Entities, June 9, 2004, pp. 10-14.
[50] IRC 414(b), (c) and (m).

governing council or membership. In some cases, the elected governing council will oversee management of each enterprise under the tribe. The variations in management illustrate the need for consultation with tribes before implementing a "one size fits all" approach to controlled group rules.

Recommendation

Section 414(c) picks up certain other trades or businesses "whether or not incorporated." Regulations promulgated under Section 414 identify other non-incorporated entities to be included, based on principals "similar to" those applied to corporations. The regulations prescribed under Code Section 414(c) do not mention tribal governments. The IRS should issue guidance clarifying that controlled group concepts will not be applied to tribal owned entities in a manner not expressly required by the ERISA or the Code.

(b) Applying controlled group rules to tribal commercial plans may cause hardship to tribal entities.

If coverage tests under Code Section 410(b) must be performed on a control group basis, many small tribal plans will need to be terminated or merged into other commercial plans. The control group testing requirements do not generally impact tribal casino plans, which in most cases have many more employees than other types of tribal entities. Instead, control group testing would adversely impact smaller traditional and cultural entities. These entities often cannot afford to offer the same benefits as are offered by plans sponsored by larger tribal entities.

For example, a farming enterprise with 20 employees and a single highly compensated employee (HCE)[51] would have difficulty passing the Section 410(b) coverage test when aggregated with a casino plan that has 2,000 non-highly compensated employees even if the casino plan has only one HCE. In that example, neither plan is set up to discriminate in favor of highly compensated employees. Unlike larger corporate employers who can take advantage of the Qualified Separate Line of Business rules, however, many tribes maintain a large number of smaller entities.[52] For example, some tribes own numerous enterprises[7] that generate revenue but would not be brought together for business reasons in a "corporate" model, such as:

- Housing authorities (can engage in tribal housing rentals and maintenance);
- Convenience stores (many tribes in remote areas have access only to tribal owned stores for groceries and other household items);

[51] IRC 414(q).
[52] The "QSLOB" rules are found at Section 414(r).

- Game and fish departments (fishing licenses, fish hatcheries and sales to state game and fish departments for stocking);
- Natural resource and recreation departments (cabin rentals, camping and hunting permits);
- Waste management services (trash collection);
- Cattle ranching and support activities (often engaged in as a means to retain culture and tradition rather than as a means to make "profits");
- Transportation services (tribal owned van services to transport members and seniors located in-remote areas);
- Job training and apprentice programs funded with federal and state grants to encourage employment opportunities on tribal reservations;
- Mining services (tribal owned operations managing tribal land minerals, oil and coal);
- Tribal land management enterprises (charged with overseeing tribal land rentals and industrial properties);
- Tribal owned halls and pavilions (rented to tribal members to perform ceremonies);
- Wood and forest services (selling trees and lumber harvested from tribal lands and from managing tribal forests); and
- Pottery and Native arts enterprises (established by tribes to maintain their culture and traditions).

Most of the above-described entities have a "revenue" component to their operations. Many of them are staffed with less than 50 employees. If Section 414 controlled group tests are applied to these entities, these entities would not qualify under the qualified separate lines of business rules. Moreover, many of these entities will have separate payrolls, separate revenue flows, and separate employee demographics making the "one size fits all" approach difficult to administer fairly.

(c) If control group testing is applied to tribal entities, then the Qualified Separate Line of Business testing exceptions should be adapted to accommodate structures unique to tribal governments.

If control group rules are applied to tribal entities, the Qualified Separate Line of Business regulations should be amended to ensure that tribes will not fail the "common management" tests simply due to their tribal constitutional structure.

6. AGGREGATION ISSUES

Tribes and tribal entities do not neatly fit within the definitions in Section 414 rules respecting aggregation. In most cases, stock ownership, voting power and other similar concepts are inapplicable to tribes and their enterprises. The difference in organization between tribes and traditional for-profit businesses raises several issues:

1. Are tribes required to aggregate their entities for coverage testing?
2. If so, what entities are included in the testing?
3. If tribes are not able to run a valid coverage test, ADP and ACP contribution testing becomes irrelevant.
4. Are the distribution rules to be enforced on a common control basis?

Recommendation

ACT recommends a moratorium on the application of all Section 414 control concepts for tribal retirement plans, pending final guidance which tailors any applicable rules to the common structures found within tribes. The interim compliance standards published in Notices 2006-89 and 2007-67 should be clarified to state that controlled group and common control rules do not apply pending the issuance of guidance.

B. Specific Issues Requiring Guidance

1. AMENDMENTS AND DETERMINATION LETTER COVERAGE

Section 906 of the PPA will require many tribes to establish separate government plans and commercial plans. Because there is currently no guidance on how to determine whether a plan should operate as a governmental or commercial plan, the IRS has granted relief indicating that separate plans, if required, need not be established until a date six months following the issuance of guidance. The IRS has, however, required that tribes operate plans in "good faith" during the interim period.

In the interim, tribes must comply with audit requirements, IRS testing, and related filings. Retirement programs must also meet deadlines for receiving IRS determination letters. Receiving determination letter provides valuable relief to tribes, often allowing them

to retroactively fix qualification errors.[53] Because the determination letter deadlines have not been extended for tribes to coincide with the PPA transition relief, tribes face a dilemma of having to split plan documents to meet the determination letter deadlines before any PPA guidance is issued. If they do not, tribes risk losing the benefits of the determination letter program. Thus, tribes find themselves caught in the dilemma of either submitting commercial or governmental plans for determination letters or waiting for PPA guidance.

Currently, governmental plans are classified as "Cycle C" plans under the determination letter program. Governmental plans were previously granted an extension to file in the current Cycle E until January 31, 2011. The Committee is without clear information on how tribes have handled the questions whether to file plans on the Cycle C deadline. The Committee anticipates, however, that some plans will not qualify as governmental plans and will therefore be "off-cycle." When tribes are required to document their commercial or enterprise plans, what will the sponsors' retroactive amendment rights be, and when will they need to file determination letter applications to preserve those amendment rights?

Recommendation

ACT recommends the following:

1) Indefinite extension of the Section 401(b) remedial amendment period for all tax-qualified tribal plans, pending issuance of guidance on Section 906, and

2) Suspension of restatement determination letter application deadlines for tribal plans pending final guidance under the PPA.

2. FORM 5500 AND PLAN AUDIT REQUIREMENTS

Many tribes maintained their retirement plans as governmental plans prior to the enactment of the PPA, and some received favorable determination letters from the Service approving the plans as governmental plans. Many of those tribes did not file Forms 5500 or engage auditors to perform plan audits under ERISA. Recently, many tribes have begun incorporating Form 5500 filings and plan audits into their operational good faith compliance with the PPA, with regard to employees who might be thought to be engaged in commercial functions. Preparing Form 5500 filings and performing audits for many of these plans will be difficult and expensive. Plans sponsors whose plans do not have an audit history and have assets attributable to both the governmental and commercial employee groups may find it difficult to separate for plan accounting purposes. As a result of the difficulty inherent in separating assets, correspondents report that audit firms prepare limited scope audits.

[53] IRC 401(b).

Most tribes are able to file the Form 5500 on a timely basis, but several are not able to obtain completed financial statements and auditor opinions on a timely or cost effective basis. When the Form 5500 is filed without the audit, tribes must allocate additional resources to responding to missing audit inquires at the same time they are conducting audits.

Recommendation

The IRS should clarify that interim compliance standards set forth in Notice 2006-89 and Notice 2007-67 do not require Form 5500 filings and plan audits as components of good faith compliance standard. Alternatively, the IRS should place a moratorium on enforcement actions related to Forms 5500 filed by sponsors of tribal retirement plans in good faith, but which are deemed to be late or incomplete, pending final guidance under Section 906.

3. TRUSTEE TO TRUSTEE TRANSFERS

Tribes experience a high number of employment transfers and rehires. The Committee anticipates that many tribal employees will move back and forth between a tribal governmental entity and an entity deemed by the Service to be a commercial entity. In the private sector, plan sponsors are able to process trustee-to-trustee transfers to move the retirement plan assets with the employee to facilitate hardship withdrawals, loans, etc. In the governmental sector, plan sponsors often allow trustee-to-trustee transfers to facilitate the purchase of service credit under a defined benefit pension plan.

State and local governments do not operate ERISA covered plans, and private sector employers do not operate governmental plans. Tribes are in the unique position of having to operate both governmental and ERISA compliant plans at the same time. In many situations, it is not possible to administer loans properly, or on a uniform basis, if transfers are not allowed. The difficulties involved in directing loan payments to the appropriate plan will result in loan compliance problems and/or the elimination of loan programs from tribal plans. The IRS will need to issue guidance on the question whether, and, if so, in what circumstances assets can be moved between commercial plans governmental plans in trustee-totrustee transfers.

Recommendation

ACT suggests that clarification of the interim compliance standards published in Notices 2006-89 and 2007-67 is required to allow trustee-to-trustee transfers among tribal governmental and tribal commercial plans, to the extent that the assets and liabilities of the commercial plans are voluntarily spun-off from the governmental plans prior to the deadline established under the final PPA guidance.

4. SHARED EMPLOYEES

Once it is determined what functions are "commercial," tribes will also need guidance with regard to those "government" employees that provide services to "commercial" enterprises, as well. For example, the tribal accounting staff may process payroll for both the "government" and a tribal owned "commercial" entity. A tribal finance director may advise on "commercial" matters. The attorney general's office or general counsel may advise on "commercial" matters.

A mechanical "percentage" test appears to be unworkable, since the percentage of "commercial" services will vary in most cases depending on particular activities over time. The general counsel, for example, may spend almost all of her time for a month or a year on contract negotiations for a commercial venture, and then spend most of the next year largely on tribal water rights. Changing an employee's plan status based on what she may be doing at a given moment would be unworkable. Allowance may be required to permit governing tribal councils to determine when and whether the employee is serving the government interests in a non-commercial manner.

Guidance is also needed with regard to the transfer of employees and benefits among different tribal entities. Many tribes have employees who transfer between different tribal entities on a frequent basis. It is also not uncommon for a "government" employee to work weekends at a tribal "commercial" entity. This presents several problems for an employer that is now subject to two sets of rules (government sector and private sector) at the same time, depending on what function an employee may be performing at any given moment.

One practical problem, for example, has to do with the 401(k) distribution event rules. If the entities are treated as a "single employer" there would not appear to be a distribution event when an employee leaves one tribal entity for employment at another. Now that most tribal entities will have to maintain separate plans for their government and "commercial" employees, tribes would benefit from guidance that allows employees to transfer their 401(k) benefits to a successor entity within the tribal control group. Without such transfer rights, the "separate plan" structure required by the PPA may create undue hardship for individual employees wanting to take plan plans or hardship distributions under the plan(s), and would create multiple accounts and recordkeeping burdens that would be confusing to employees and costly to employers.

5. SERVICE CREDITS

There are also a number of other compliance issues which must be confronted as a result of the same employer being subject to two sets of rules. The commercial plan, for

example, will be subject to ERISA service crediting rules and Code Section 410(b). The government sector plan would not. When an employee transfers between commercial and government employment, tribal administrators and others will need to know what service must be counted and retained. Therefore, guidance is required to determine proper accounting for service of employees who participate in both types of plans.

IV. CONCLUSION

The ACT offers this report as a beginning point for the much needed discussions and actions which must be taken to support tribal employee pension plans. Until the tribes receive clear guidance from the IRS, and solutions for uneven treatment of their pension benefit plans as compared to state and local governments, tribes' ability to offer tax qualified employee retirement plans will be impaired.

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ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Exempt Organizations:
Group Exemptions – Creating a Higher Degree of Transparency, Accountability, and Responsibility

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June 15, 2011

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I. Executive Summary

Each year, tens of thousands of organizations file individual applications with the Internal Revenue Service (IRS) for recognition of their tax-exempt status. But for more than seventy years, the IRS has also had procedures permitting certain affiliated organizations to obtain recognition of their exemption on a group basis, rather than by filing separate applications. Under these group procedures, one of the organizations (called the central organization) submits a request for recognition of exemption for a group of organizations that are affiliated with it and under its general supervision or control (called the subordinate organizations). If the IRS grants this request, the central organization is authorized to add other similar subordinates to the group, as well as to delete subordinates that no longer meet the group exemption requirements. Central organizations (other than churches) are required to notify the IRS annually of additions and deletions to the group exemption. As a result of the group exemption procedures, subordinate organizations covered by group exemptions are relieved from filing their own individual applications for recognition of exemption with the IRS. The central and subordinate members of a group are covered by all the same rules relating to their exempt status as other exempt organizations, including the requirement to file annual Forms 990. Group exemption holders, however, have the option of filing a group or aggregated Form 990 for two or more of their subordinate organizations, thus relieving those subordinate organizations from having to file separate Forms 990.

There is no question that the group exemption procedures have simplified the process for obtaining exempt status for hundreds of thousands of organizations—and for the IRS—over the years. However, there have been some significant changes in the law and regulatory environment affecting the tax-exempt sector since the issuance of Revenue Procedure 80-27, the most recent group exemption revenue procedure. Among other things, the Pension Protection Act of 2006 (PPA) made significant changes in the laws governing exempt organizations, including the treatment of organizations classified as supporting organizations under section 509(a)(3) of the Internal Revenue Code. The Form 990 has been significantly revised to require a much higher degree of disclosure regarding the organizational structure, activities, governance, revenues and expenditures of exempt organizations. Exempt organizations make their Forms 990 available, easily and free of charge, on their own websites. They are also available on other websites such as GuideStar.org. Thus, Forms 990 are readily accessible to the public, the media and other stakeholders in the nonprofit sector as a source of information about specific exempt organizations. And states are increasingly reliant on the information provided on Form 990 for their own regulatory purposes.

The impact of these and other recent developments in the tax-exempt sector on the group exemption procedures merits consideration. The consistent theme has been to promote a greater degree of **transparency**, **accountability**, and **responsibility**, three tax policy objectives that underlie federal and state laws,

regulations, rules and procedures within the exempt sector. This project, undertaken at the suggestion of the IRS, grew out of the ACT's belief that the time is right to examine the group exemption procedures to consider whether they are consistent with these three tax policy objectives, and, if not, whether group exemptions should be retained or if changes should be made to enhance the ability of the group exemption procedures to achieve such objectives. As we pursued the project, we discovered various challenges and frustrations with the group exemption procedures on the part of the IRS and group exemption holders alike. While some of these appear to stem from inherent limitations of existing technology and internal processes that are not readily addressed, others—including some issues involving churches (which represent a very large body of group ruling holders)—raise legitimate concerns for which solutions should be sought. We have made note of these where relevant and appropriate.

This report explains the process that the ACT followed; describes the historic and current framework for group exemptions and group returns; and examines the benefits, challenges and limitations of group exemptions and group returns. It explains the basis for the ACT's determination that group exemptions should be retained, but the current group exemption procedures should be updated. Finally, the report makes the following recommendations as to how the group exemption procedures could be revised to achieve greater transparency, accountability and responsibility.

1. Allowing group exemption holders to file group Form 990 returns does not provide the IRS, the states, or the public with adequate transparency about the activities of subordinate organizations covered by a group exemption, or serve as a mechanism to promote adequate accountability by the subordinate organizations on an individual basis. We recommend eliminating group returns by amending Treasury Regulations section 1.6033-2(d) to remove the authority of central organizations to file group returns.

2. Revenue Procedure 80-27 does not define or explain how central organizations are expected to exercise on-going general supervision or control over their subordinate organizations. This lack of guidance makes it difficult for group exemption holders to exercise appropriate responsibility with respect to their subordinate organizations and creates a lack of accountability in meeting unstated and unknown expectations. We recommend updating Revenue Procedure 80-27 to provide such guidance and that the revision be issued in proposed form for public comment. As part of this process, special consideration should be given to the development of appropriate standards to address the varied organizational structures and unique legal status of churches.

3. Group exemption holders are not required to disclose to the public their list of subordinate organizations or any other information about the composition of the group. Nor are they required to disclose to the public or the IRS the procedures they follow to exercise on-going general supervision or control in compliance with Revenue Procedure 80-27. This disclosure vacuum

contributes to a lack of transparency and accountability with respect to group exemption holders. We recommend requiring group exemption holders that have a Form 990 filing requirement to disclose, on Schedule O of the Form 990, information about the composition of the group and how the central organization exercises general supervision or control. To ensure that all groups provide this disclosure, we recommend that each central organization with a Form 990 filing requirement be required to file Form 990, even if it would otherwise be eligible to file Form 990-EZ or 990-N.

4. While section 501(c)(3) subordinate organizations covered by group exemptions are generally listed in the Exempt Organizations Business Master File (EOBMF),[1] they are not listed in Publication 78, making it impossible for donors to verify readily the ability of section 501(c)(3) subordinate organizations to receive tax-deductible charitable contributions. Recent IRS efforts to educate donors about their ability to rely on group exemption confirmations given by the central organization, while appreciated by the sector, have met with mixed success at best. We recommend that the IRS work with section 501(c)(3) group exemption holders, including churches, to develop workable new options for including subordinate organizations in Publication 78 or otherwise providing donors with additional information regarding the deductibility of contributions that exists for other tax-exempt charities.

5. Changes made by the PPA in the definitions and tax laws governing section 509(a)(3) supporting organizations raise a question as to whether it continues to be appropriate for them to be included in a group exemption ruling. On balance, we believe that "Type III" supporting organizations should not be included in a group exemption ruling. We recommend that this be addressed as part of a project to issue an updated version of Revenue Procedure 80-27 for public comment.

6. Finally, we recommend that there be a significant transition period for existing groups to come into compliance with any changes to the group ruling procedures. Moreover, special consideration should be given to existing church group exemptions, as they are some of the largest and oldest of all group exemptions. (Some church group exemptions have tens of thousands of subordinate organizations and some have been in place for 60 years or more.) We recommend the IRS seek comment from existing group exemption holders before setting any time limits for a transition period.

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[1] Historically, subordinate organizations in church group rulings have generally not been listed in the EOBMF. However, it is the ACT's understanding that current IRS policy is to include church group ruling subordinates in the EOBMF if the central organization, through annual updates or otherwise, voluntarily provides the IRS with information about these organizations.

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II. Statement of Problem and Project Objectives

A. Problem

There have been many significant changes in the laws affecting tax-exempt organizations since the issuance of the first group exemption in 1940. Laws have been enacted and regulations issued requiring section 501(c)(3) organizations (other than churches) to seek recognition of exemption and imposing annual information filing requirements (Form 990) on most categories of exempt organizations (other than churches). Changes have been made in the laws governing categories of section 501(c)(3) organizations, including the private foundation excise taxes in Chapter 42 of the Internal Revenue Code and, most recently, the laws governing supporting organizations.

Laws have also been enacted and regulations issued to promote greater access to information about tax-exempt organizations, for example, requiring that annual information returns (Forms 990) be made available to the public. (And institutions such as GuideStar provide online the Forms 990 for thousands of organizations.) At the urging of the Congress, the states, and the public, the IRS has undertaken more recent initiatives to improve the quality and accessibility of information about exempt organizations by redesigning the Form 990. The IRS has also put Publication 78, its *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, on line, making it easier for donors to check the section 501(c)(3) status of organizations before making a grant or charitable contribution.

For many years, the IRS regularly updated its group exemption procedures in light of the changes in law, regulations and procedures. However, no changes have been made to the group exemption procedures since 1980, raising the question as to whether the existing procedures remain adequate for the intended purposes. In addition, the IRS and group exemption holders have expressed frustration with various aspects of the existing group exemption procedures, and this also warrants consideration.

B. Project Objectives

Over the past three decades since the IRS last updated the group exemption procedures, substantial attention has been focused on the importance of transparency, accountability, and responsibility within the tax-exempt sector. The laws, regulations and procedures governing exempt organizations have, at their heart, these three tax policy considerations. While there is no statutory or regulatory definition of these terms, we believe they are commonly understood to have the following meanings.

Transparency refers to making information available regarding the organization's structure, operations, activities, finances, and tax status – such as the type of information that is now required on Form 990 for organizations that have a filing

requirement. A wide variety of stakeholders — the IRS, the states, donors, the public, the media, and others — rely on this information for regulatory and information purposes. Accountability refers to meeting obligations to the same group of stakeholders to use tax-exempt funds in a manner consistent with the intended purposes. Responsibility refers to compliance with the laws and rules governing the organization's exempt status.

The objectives of this project are to examine the group exemption procedures to see whether they continue to serve a useful purpose, and to consider whether changes are needed to increase the transparency, accountability and responsibility of central organizations holding group exemptions and the subordinate organizations covered by them.

III. Process

The ACT reviewed all formal and informal guidance issued by the IRS relating to group exemptions and the filing of group returns, including regulations, revenue procedures, publications, the Internal Revenue Manual, private letter rulings, and the Form 990 instructions for the filing of group returns. The IRS provided historical information about the development of group exemptions, along with statistical data regarding the number of group exemptions and the section 501(c) subsection classification of the central and subordinate organizations. We were also provided some statistical information about group returns.

The ACT conducted a series of interviews with IRS officials and staff. These interviews focused on issues, challenges, and concerns associated with the group exemption procedures from the IRS perspective, as well as the feasibility of various options that might exist for making changes to the procedures. The ACT received a great deal of helpful information about the history of the group exemption procedures as well as challenges associated with applying the normal IRS procedures in the context of group exemptions.

The ACT also obtained information from members of the National Association of State Charity Officials (NASCO).[2] In order to determine the impact of group exemptions and group returns on the exercise of state charity regulators' authority and the dissemination of information to the public, a member of the ACT collected information from, and discussed the group exemption and group return procedures, with over 15 state charity regulators.

In addition, the ACT collected information and documents from ten large and medium-sized church denominations that hold group exemptions, including responses to a questionnaire prepared by the ACT. Several members of the ACT met in person with representatives from eight denominations, both individually and as a group. These representatives shared information about the operation of their group exemptions and discussed issues they identified with the group exemption procedures.

Members of the ACT also interviewed a number of non-church group ruling holders and subordinate organizations exempt under sections 501(c)(3), 501(c)(4), 501(c)(7), 501(c)(9), 501(c)(14), and 501(c)(19). These organizations ranged from large, nationwide organizations, to smaller regional and state-based entities.

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[2] The National Association of State Charity Officials is made up of representatives of state agencies, including Attorneys General, Secretaries of State and Commissioners of Consumer Affairs whose responsibilities include oversight of tax-exempt entities. That oversight includes ensuring that charitable assets are appropriately managed, that donor intent is fulfilled, and that fraudulent fundraising is remedied.

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IV. Background on Group Exemptions

A. Number and Profile of Group Exemption Holders

There are currently over 4,300 group exemptions covering approximately 500,000 subordinate organizations. These statistics do not include church group exemptions because they are not required to file annual information reports with the IRS regarding additions and deletions of subordinate organizations from their group exemptions. From our conversations with church group exemption holders, we learned that some church group exemptions cover thousands and even tens of thousands of subordinate organizations. Based on this information, we estimate that there are something on the order of 100,000 to 150,000 churches and other subordinate organizations covered by group exemptions, in addition to the numbers listed above. Also, approximately 600 – 700 of the more than 4,300 central organizations holding group exemptions elect to file group Form 990 returns on behalf of some or all of their subordinate organizations.

Group exemptions exist for many categories of exempt organizations, including subordinate organizations exempt under sections 501(c)(3), (4), (5), (6), (7), (8), and (19). Section 501(c)(3) organizations comprise the largest single segment of the group ruling universe. Approximately 2,500 of the 4,300 group exemptions are held by section 501(c)(3) central organizations, and there are approximately 250,000 section 501(c)(3) subordinate organizations (again, excluding churches, their integrated auxiliaries and affiliated subordinates). Some of the group exemptions cover a relatively small group of subordinate organizations (as few as one); others cover a very large group of subordinate organizations (as many as 30,000 – 40,000 or more).

Group exemption holders include many well-known section 501(c)(3) organizations such as the American Cancer Society, Habitat for Humanity, and the National Association for the Advancement of Colored People. Also, many large religious denominations hold group exemptions, including the Catholic Church, United Methodist Church, Presbyterian Church (U.S.A.), Seventh-day Adventist Church, and The Church of Jesus Christ of Latter-day Saints, to name just a few. Other well-known group exemption holders include labor unions (*e.g.*, the International Brotherhood of Teamsters), Hillel The Foundation for Jewish Campus Life, Veterans of Foreign Wars, Knights of Columbus, Benevolent and Protective Order of Elks, Rotary International, and certain state League of Women Voters and PTA organizations.

B. Pre-1980 IRS Group Exemption Procedures

The earliest group exemptions apparently pre-date the Internal Revenue Code of 1939, although IRS records indicate that the first “official” group exemption was issued on March 14, 1940. Until the issuance of Revenue Procedure 68-13, the IRS handled group exemption requests on a case-by-case basis, without any formal administrative guidance on the process or requirements. Revenue

Procedure 68-13 established the substantive requirements for inclusion in a group exemption, as well as the procedures for obtaining a group exemption, the annual filing requirements to maintain the group exemption, and the consequences of terminating the group exemption.

Revenue Procedure 68-13 provided that a "central" organization already recognized as exempt could apply for exemption for "subordinate organizations" that met four requirements: (i) they were affiliated with the central organization; (ii) they were subject to the central organization's "general supervision or control;" (iii) they were all exempt under the same paragraph of section 501(c), although not necessarily the same paragraph as the central organization; and (iv) they provided written authorization to be included in the application for group exemption.

Revenue Procedure 68-13 required the central organization to submit a letter, signed by one of its principal officers, verifying the existence of affiliation and general supervision or control over the subordinate organizations; describing the principal purposes and activities of the subordinates; providing a sample of the governing document for the subordinates; affirming (to the best of the officer's knowledge) that the subordinates operated in accordance with the stated purposes; and confirming that each subordinate had provided written authorization to be included in the group ruling. The central organization also had to include a list of the names, addresses, and employer identification numbers of the subordinates to be included in the group exemption.

Once a group exemption was granted, the central organization was responsible for determining whether new subordinates met the requirements to be covered by the group exemption, for monitoring the continued compliance of existing group members with the requirements for exemption and for keeping the IRS updated on additions, deletions, and other changes to the group's subordinate organizations. Revenue Procedure 68-13 imposed an annual filing responsibility on central organizations, requiring them to file an annual report with the IRS providing information regarding "all changes in the purposes, character, or method of operation" of the subordinates in the group exemption, as well as the names, addresses, and EINs of subordinates that (i) have changed their names or addresses, (ii) are no longer included in the group exemption, and (iii) have been newly added to the group exemption. Revenue Procedure 68-13 provided that a central organization could submit an annual directory to meet the annual filing requirement, as long as it annotated the directory to include the three categories of information required in the preceding sentence. With respect to newly added subordinates, central organizations were also required to provide the same information required in the original request, or to confirm that the information submitted in the original request is applicable "in all material respects" to the new subordinates.

Revenue Procedure 68-13 explained the consequences of a termination or revocation of the group exemption, which could occur if the central organization

dissolved, lost its exemption or failed to meet the annual filing requirements, as well as the consequences if one or more of the subordinate organizations were determined not to qualify for exemption.

Finally, Revenue Procedure 68-13 addressed group exemptions and listings in Publication 78, *Cumulative List - Organizations Described in Section 170(c) of the Internal Revenue Code of 1954*. Specifically, Revenue Procedure 68-13 stated that, if a central organization holding a group exemption is eligible to receive deductible charitable contributions as provided in section 170, the central organization will be listed in Publication 78, but the names of the subordinates covered by the group exemption letter will not be listed individually. However, Revenue Procedure 68-13 stated that the "identification of the central organization will indicate whether contributions to its subordinates are also deductible."

The IRS issued three subsequent Revenue Procedures updating the group exemption procedures, although the principal provisions of Revenue Procedure 68-13 remain largely unchanged. Revenue Procedure 72-41, which superseded Revenue Procedure 68-13, added a new requirement that subordinates covered by a group ruling could not include organizations classified as private foundations under section 509(a). Revenue Procedure 72-41 also withdrew the provision allowing a central organization to submit an annotated annual directory to satisfy the annual filing requirement, requiring instead that all central organizations submit annual information in the same format. Finally, Revenue Procedure 72-41 deleted the language in Revenue Procedure 68-13 discussing group exemptions and listings in Publication 78.

Revenue Procedure 77-38, which superseded Revenue Procedure 72-41, made several fairly minor changes in the group exemption process. It provided that foreign subordinates could not be covered under a group exemption. It also required that subordinates listed in the application for the group exemption must have been formed within the 15-month period prior to the date the group exemption application is submitted, if those subordinates were subject to section 508(a) of the Code.[3] Revenue Procedure 77-38 also expanded the information required to be provided by the central organization in the application for a group exemption to include "a detailed description of the purposes and activities of the subordinates including the sources of receipts and the nature of expenditures." Finally, it added a requirement that private school subordinates comply with Revenue Procedure 75-50 (requiring racially nondiscriminatory policies with regard to admissions, programs, and financial assistance), and spelled out in more detail the conditions for continued effectiveness of a group exemption.

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[3] Note this 15-month time period is the usual deadline for an organization to file an application for exemption with the IRS if it seeks recognition of its exempt status retroactive to the date the organization was formed. Treas. Reg. § 1.508-1(a)(2).

C. Current IRS Group Ruling Procedures

1. Revenue Procedure 80-27

Revenue Procedure 80-27 sets forth the current group exemption procedures. It retains most of the provisions of Revenue Procedure 77-38 (described above). Changes from the prior Revenue Procedure relate to the time for filing the annual report (changed from 45 to 90 days before the close of the central organization's tax year), clarifications to the application of the 15-month rule discussed above, and the addition of a requirement that all subordinates must have the same accounting period as the central organization if they are to be included in a group Form 990 return filed by the central organization.

2. Publication 4573

In 2006, the IRS issued Publication 4573, which contains a series of questions and answers about group exemptions. That publication, most recently revised in 2007, provides plain-language information about some of the most important aspects of group exemptions. For the most part, Publication 4573 is consistent with Revenue Procedure 80-27, although it makes one substantive change – it states that churches holding group exemptions are not required to file an annual report updating the IRS on changes in their subordinates. The obvious impact of this change is to leave the IRS without updated and accurate information about the identity of the subordinates covered by church group exemptions, at least for those churches that do not, voluntarily, submit such annual reports. However, some church group ruling holders we spoke with said this change simply recognized a long-standing administrative practice of the IRS (which has since been changed) not to update its records with information submitted in church group exemption annual reports.

3. 1994 ABA Tax Section Comments on Revenue Procedure 80-27

Although Revenue Procedure 80-27 has been existence for more than three decades and has been modified, at least informally, by Publication 4573, the IRS has not initiated a formal process to review and update the group exemption procedures. In 1994, the Exempt Organizations Committee of the Section of Taxation of the American Bar Association submitted comments to the IRS recommending that Revenue Procedure 80-27 be modified to remove the requirement that the central organization have "general supervision or control" of subordinates, at least in the case of churches and religious organizations, and to replace that with a requirement that the central organization have sufficient "affiliation bonds" that it will be able to provide accurate, timely, and regular information to the IRS regarding the subordinates covered by the group exemption.

These comments were prompted by several considerations, including the following:

(1) many churches and other religious organizations are prohibited by theological doctrine or practices from controlling or supervising other entities within the denomination or religious association; and

(2) central churches and religious associations should not have to represent that they control or supervise affiliated entities, since such representations are frequently used against the central church or religious association in tort litigation.

The latter consideration is reflected in the case of *Barr v. United Methodist Church*, 90 Cal. App. 3rd 259, 153 Cal. Rptr. 322 (1979), in which the court used, in part, information from a central organization's group ruling application to hold that the *entire denomination* could be sued in a dispute involving some retirement homes affiliated with a regional body of the church.

D. Donor Reliance on Group Exemptions

As a general matter, a donor making a contribution to a charitable organization is entitled to rely on the organization's listing in Publication 78 for assurance that the contribution will be deductible. When an organization loses exemption, the IRS removes it from Publication 78, and donors can no longer rely on the organization's original exemption letter. Publication 78 is available on-line, and it is used by a wide variety of donors, including individuals, foundations, and companies making matching gifts, to check the tax-exempt status of an organization before making a contribution or grant.

Generally, subordinates covered by a group exemption are not listed individually in Publication 78, but donors are entitled to rely on confirmation from the central organization that the subordinate is covered by the group exemption. Publication 4573 specifically addresses this point with two questions on how donors may verify that a subordinate is covered by a group exemption, and what they may rely on in making a charitable contribution to a subordinate that does not have its own exemption. These questions and answers are as follows:

How do I verify that an organization is included as a subordinate in a group exemption ruling?

The central organization that holds a group exemption (rather than the IRS) determines which organizations are included as subordinates under its group exemption ruling. Therefore, you can verify that an organization is a subordinate under a group exemption ruling by consulting the official subordinate listing approved by the central organization or by contacting the central organization directly. You may use either method to verify that an organization is a subordinate under a group exemption ruling.

How do donors verify that contributions are deductible under section 170 with respect to a subordinate organization in a section 501(c)(3) group exemption ruling?

Donors should consult IRS Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, or obtain a copy of the group exemption letter from the central organization. The central organization's listing in Publication 78 will indicate that contributions to its subordinate organizations covered by the group exemption ruling are also deductible, even though most subordinate organizations are not separately listed in Publication 78 or on the EO Business Master File. Donors should then verify with the central organization, by either of the methods indicated above, whether the particular subordinate is included in the central organization's group ruling. The subordinate organization need not itself be listed in Publication 78 or on the EO Business Master File. Donors may rely upon central organization verification with respect to deductibility of contributions to subordinates covered in a section 501(c)(3) group exemption ruling.

E. Group Returns

In general, the fact that a group exemption exists does not change the Form 990 filing requirements for either the central or subordinate organizations. A central organization and all of the subordinate organizations must each file a Form 990, unless the organization satisfies a filing exception (such as for churches). However, the central organization may file a group return on behalf of those subordinate organizations that elect to be included in the group return.[4] *See* Treas. Reg. § 1.6033-2(d).

With the increased disclosures contained in the redesigned Form 990, the proper completion of a group return filed by a central organization on behalf of some or all of its subordinate organizations creates challenges. In order to file a complete and accurate group return, the central organization is required to collect the appropriate data from each of the subordinates — in effect, requiring each subordinate to provide the central organization with all of the same information it would need to complete its own Form 990. The central organization is then required to aggregate the data from all subordinate organizations that have elected to join the group return and to report this information in the group return in accordance with Appendix E of the instructions for the Form 990.

These instructions on group returns require the reporting of some required Form 990 information on an aggregate basis. For example, when reporting the number of volunteers on the Form 990, Part I, line 6, the central organization is required

[4] If a central organization is subject to a filing requirement, it must always file its own separate return, regardless of whether it files a group return for some or all of the subordinate organizations.

to aggregate the total number of volunteers for all of the subordinate organizations included in the group return. But other information is required to be reported on an individual basis, which may present a reporting challenge. For example, the instructions provide that answers to the yes/no questions in the return must accurately reflect the activities of each of the subordinate organizations when the answers are not the same for all subordinate organizations in the group return. Thus, the central organization must explain in Schedule O the different answers for the different subordinate organizations.

As another example of this dichotomy of aggregate and separate reporting in a group return, the compensation of the officers, directors, trustees, and key employees of each subordinate organization is required to be disclosed in both Part VII of the Form 990 and Schedule J. However, information with respect to highly compensated employees, and independent contractors, is only required to be reported for the highest paid among the whole group of subordinates, and not on a subordinate-by-subordinate basis.

In some cases, completing the Form 990, as required in the instructions, may mask potential issues that exist with respect to individual subordinates. For example, in the case of section 501(c)(3) organizations, the Form 990 instructions require reporting of public support information in Schedule A on an aggregate basis. This makes it impossible to determine whether each individual subordinate meets the requisite public support test. This is a particular concern, because the aggregate reporting could easily mask the fact that an individual subordinate organization has failed the public support test and should be properly classified as a private foundation. Private foundations are not eligible to be included in a group exemption and are, of course, subject to many restrictions that are not applicable to public charities. There is a similar issue with respect to the reporting of lobbying information; the aggregate reporting does not allow the IRS (or the public) to discern on a group return if each individual section 501(c)(3) group member is operating within its lobbying limits.

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V. Information Obtained from Stakeholders

In conversations with the IRS, we discussed its concerns about whether the current group exemption process provides sufficient transparency, accountability, and responsibility. We also discussed alternatives to the group exemption process if it were not retained, including whether existing group exemption holders should be grandfathered or whether a new expedited review process might be created to allow subordinate organizations covered by existing group exemptions to seek individual recognition of exemption on a simplified basis. These were preliminary conversations intended to allow the ACT to gain an understanding of the options that might be available.

The ACT also received very helpful comments from NASCO members. While one NASCO member responded that these group exemption procedures did not impact its ability to fulfill its regulatory responsibilities, members from approximately 15 other states raised concerns that group exemptions, and in particular group returns, present state regulators with problems in enforcing state law and make it difficult for group members to comply with those laws. The problems identified by NASCO members included the following:

> *Difficulty identifying which subordinate organizations covered by a group return are active in a particular state* — One respondent claimed that the lists of subordinates included in group returns are "often nearly impossible to decipher and at the very least difficult to review in order to find [a] specific organization," especially when an individual organization has amended its Articles of Incorporation to change its name and this change is not made known to the central organization. This problem is exacerbated by the fact that many members of groups have similar names, both to other members of the same group and to entirely unrelated groups.
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> *Difficulty identifying officers, directors and employees of subordinate organizations* — Respondents noted that the group return does not identify those individuals — officers, directors, and employees — who oversee and manage the individual subordinates, and who are accountable to the states in which they operate. It is those individuals (rather than the officers and directors of the central organization, which may be located elsewhere), who are accountable to the states and to whom charity regulators look for compliance and accountability. The inability to identify them ties the hands of state regulators in seeking evidence and exercising their enforcement authority.
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> *Inability to break down financial information among group members* — Respondents noted that group returns do not break down financial information among the subordinate organizations and as a result there is no accountability to the states by the individual organizations over which they have regulatory authority. For most states, a group return does not

satisfy the filing requirement applicable to a subordinate organization because such a return does not provide a separate accounting of the revenue and expenses of the individual state registrant. Likewise, group returns do not provide meaningful information to citizens who want to inquire about a particular subordinate.

Impact on compliance with state law — Some NASCO respondents expressed a general concern that the group exemption process may impact the subordinate organizations' compliance with state law. For example, many states do not recognize group exemption at the state level and instead require registration of and filing by each legal entity subject to their jurisdiction. Subordinate organizations covered by a group exemption may not be aware that they have to obtain their own individual state tax exemptions and satisfy individual state filing requirements. In the case of churches, some state definitions of "religious organization" are different from the definition in the Internal Revenue Code, so some organizations that are part of a group exemption and do not have an IRS filing requirement, nevertheless, may be required to register and file annual reports in certain states. For example, a group home included in the IRS group exemption for a church may not be exempt from registration pursuant to a state law that only exempts houses of worship, and may be unaware of the state law requirement.

Lack of documentation for state registration requirements — Some states require exempt organizations to file, as part of their registration, a copy of the registrant's IRS Form 1023. Subordinate organizations may not have access to the form filed by the central organization and therefore have difficulty meeting this requirement, or the central organization's application for a group exemption may have been submitted years before a particular organization was formed or became a member of the group and therefore may not appropriately describe the activities and history of the particular group member.

The ACT also met, collectively and individually, with representatives of church group exemption holders. The principal issue raised by church group exemption holders involved the challenge associated with providing donors with acceptable levels of assurance as to the deductibility of contributions made to subordinate organizations covered by a group exemption. Another issue that was raised related to the interpretation of the general supervision or control standard of Revenue Procedure 80-27 in the context of churches and religious organizations. Also, some church group exemption holders expressed complaints about inadequate training given to IRS personnel who respond to calls from donors and others, inquiring about the tax-exempt status of their subordinate organizations. They also expressed frustration over numerous incidents related to inaccurate information in IRS databases concerning their subordinate organizations.

VI. Analysis of Group Exemptions and Group Rulings

The ACT's analysis of the group exemption procedures focused on three questions: (1) should the group exemption mechanism be retained; (2) do the current group exemption procedures adequately achieve the tax policy objectives of transparency, accountability and responsibility; and (3) how can the current procedures be revised to enhance such tax policy objectives?

A. Should the group exemption mechanism be retained?

The ACT believes that the group exemption process provides an appropriate mechanism for central organizations to seek recognition of exemption on a group basis for organizations under their general supervision or control. The original objective of the group exemption procedures was to lessen the administrative burden on subordinate organizations and on the IRS, and we believe that remains a valid rationale for subordinate organizations and the IRS alike.

With respect to the administrative burden on subordinate organizations, we note that the application for recognition of exemption (Form 1023 for section 501(c)(3) organizations and Form 1024 for most other categories) has become more complex over the past decade. Form 1023, in particular, became significantly more complex when it was last revised in 2006. According to the Form 1023 instructions, the estimated time to prepare and assemble the Form 1023 (without any schedules) is approximately 10.5 hours, to learn about the law or the form is approximately 5 hours, and the estimated recordkeeping time associated with preparation of the form is nearly 90 hours.[5] While we take these estimates with a grain of salt, we believe they are reflective of the level of effort associated with preparing and filing a Form 1023. Also, there is a substantial user fee to file the Form 1023. If the applying organization's average annual gross receipts have exceeded or will exceed $10,000 annually over a four-year period, the user fee is $850. For all other organizations, the user fee is $400.

Because many, if not most, of the subordinate organizations currently covered by group exemptions have substantially the same structure (which has been approved by the IRS in the context of the central organization's group exemption application) and are under the general supervision or control of a central organization, it seems unnecessary to require them to go through the time and expense of submitting separate applications for recognition of exemption. Furthermore, the group exemption process also ensures uniform and consistent treatment of similarly situated organizations, something that is not assured through the normal exemption application process, in which it is not uncommon for applications submitted by similarly situated organizations to receive disparate treatment.

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[5] The Paperwork Reduction Act requires the IRS to provide an estimate, for all tax forms, of the time required for recordkeeping, learning about the law, preparing the form and copying, assembling, and sending it to the IRS. This information can be found on page 24 of the Instructions to Form 1023.

The analysis is similar with respect to the administrative burden on the IRS of individual exemption applications. In recent years, the IRS has made an administrative decision to streamline its application review process for most organizations based on a determination that it can carry out its tax administration responsibilities with a fairly low level of review for most exemption applications. The reason is that many exemption applications are for organizations that are very similar to other existing exempt organizations and by their nature do not require significant analysis. Retaining the group exemption process is a logical corollary of that decision, and has the added advantage of eliminating what would generally be a much more substantial burden on the organizations themselves. Specifically, if group rulings were eliminated, hundreds of thousands of (former) subordinate organizations would need to file individual exemption applications with the IRS. These applications would be in addition to the already significant normal volume of applications currently being processed with limited IRS resources. Because many of these organizations would be similar to each other or to other organizations that have already been granted exemption, presumably many of these applications would not require substantial review by the IRS. But that, in turn, raises the question of what then is the relative value to the IRS, the public, donors, and others of a minimal review of all these applications when balanced against the time and expense incurred by the organizations in filing them.[6]

Moreover, in many cases, we believe that the IRS will get a higher degree of on-going compliance with the requirements for exemption by retaining the group exemption procedures. One of the requirements of Revenue Procedure 80-27 is that the central organization exercise on-going general supervision or control over subordinate organizations covered by the group exemption. Central organizations have the authority to delete subordinate organizations from the group exemption if they no longer satisfy all the requirements to be in the group. This provides for an on-going level of oversight by the central organization that can be far greater than what would otherwise exist at the IRS level alone. Even for large groups, the number of their subordinate organizations is dwarfed by the approximately 1.8 million tax-exempt entities regulated by the IRS. In theory at least, the central organization is able to supervise and scrutinize its subordinates more closely — and remove entities that are not complying with IRS requirements more quickly — than the IRS. A good example of this is church group exemptions. By statute, churches, their integrated auxiliaries, and conventions or associations of churches do not have to apply for exemption or file Forms 990. Thus, many of these organizations are virtually invisible to the IRS. The church audit procedures under section 7611 of the Internal Revenue Code (IRC) further limit the ability of the IRS to exercise oversight over these organizations. Hence, the central organization of a church group ruling is in a

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[6] It should also be noted that most subordinate organizations in non-church group exemptions currently file annual information returns (Forms 990), which provide more current information about these organizations than an exemption application that would only be filed once.

much better position than the IRS to monitor the activities of the group's subordinates.

In the ACT's interviews with group ruling holders, we found a number of central organizations that provide a level of supervision or control of their subordinate organizations that enhances and ensures their compliance with the requirements for obtaining and maintaining tax-exempt status. In the case of many group exemptions, we believe that the initial and ongoing scrutiny exercised by the central organization — which is often concerned with doctrinal or operational consistency, operational focus and/or reputational risk for the group members — is more probing than that of the IRS. Moreover, as discussed below, we believe that providing central organizations with clearer guidance regarding their general supervision or control obligation, and providing the IRS with more information about how central organizations are fulfilling that obligation, will significantly improve transparency, accountability, and responsibility for group exemptions.

The group exemption process provides another benefit to the IRS with respect to its administration of the tax laws in the case of organizations that are not required to seek recognition of exemption on an individual organization basis, including churches and non-501(c)(3) organizations. Under the group exemption procedures, all categories of exempt organizations — including churches and non-501(c)(3) organizations — must apply to the IRS to obtain a group exemption for their subordinate organizations. This provides the IRS with a base of information that it might not otherwise have about a significant cadre of exempt organizations. This is particularly the case with respect to churches, which, as noted above, would otherwise be invisible to the IRS. Moreover, even though churches are not required to file an annual report to the IRS listing organizations added to and deleted from the group exemption, some voluntarily choose to do so, which provides the IRS with updated information about their subordinates that can be incorporated into the EOBMF.

The principal arguments against retaining group rulings relate to concerns about a lack of transparency, accountability, and responsibility inherent in the process. The ACT believes that eliminating group rulings would, to a limited degree, increase transparency, accountability, and responsibility — each organization that would have been a group member would be required to file an individual exemption application. This would address some of the concerns raised by state regulators, and donors would have full access to the individual exemption applications. Moreover, each entity that receives recognition of its exempt status through an individual application would be listed in the EOBMF and, if recognized as a section 501(c)(3) organization, Publication 78, solving the concerns raised about easily verifying exempt status.

However, eliminating group rulings (either entirely or prospectively) would also raise several significant concerns:

Retroactive Revocation of Exempt Status — If group exemption rulings were eliminated, existing group ruling members would likely raise legal objections that such an action would be a retroactive revocation of their exempt status by the IRS. As a legal matter, the IRS would presumably argue that no revocation occurred because the group ruling members never received a determination letter from the IRS recognizing their exempt status. In other words, there was no revocation by the IRS because the IRS never granted the individual group ruling members any status that could be revoked. On the other hand, group ruling members could argue that they followed the IRS's own group ruling procedures to establish their exempt status, and those procedures did not require that they apply to the IRS for recognition of that status.[7] Hence, in their view, an administrative action by the IRS to eliminate group rulings would be, at least, a *de facto* revocation of their exempt status by the IRS, and it is certainly conceivable that former section 501(c)(3) group ruling members might file a declaratory judgment action under IRC section 7428.[8] While we express no view on the ultimate outcome of such declaratory judgment actions, we do not believe that the likely arguments to be made by affected group ruling members would be easily dismissed.

Disparate Treatment Resulting from Prospective Elimination of Group Rulings — Even a prospective (only) elimination of group rulings raises some serious concerns. If existing group exemption holders are allowed to retain their group status, and the group ruling process is eliminated only on a going-forward basis, organizations that would otherwise qualify for group status would raise fairness concerns, and may be able to raise legal issues about disparate treatment of similarly situated organizations.[9] (These same issues could also arise if existing group rulings were "frozen," i.e., permitting existing subordinates to continue to be covered by the group ruling, but not allowing new subordinates to be added.) As an

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[7] Also, the Treasury Regulations specifically exempt subordinate organizations (other than private foundations) covered by a group exemption letter from the usual requirement that section 501(c)(3) organizations must file an application with the IRS for recognition of exemption. Treas. Reg. § 1.508-1(a)(3)(i)(c).

[8] *See* IRC § 7428(a)(1)(A) (granting the authority to file a declaratory judgment action in the United States Tax Court, the United States Court of Federal Claims, or the district court of the United States for the District of Columbia with respect to the "continuing qualification of an organization as an organization described in section 501(c)(3)").

[9] In the context of retroactive application of tax regulations and rulings, courts have required that the IRS treat similarly situated taxpayers in the same manner. *International Business Machines Corp. v. United States*, 343 F.2d 914, 920 (Ct. Cl. 1965) (stating that "[e]quality of treatment is so dominant in our understanding of justice that discretion, where it is allowed a role, must pay the strictest heed"). In other contexts, courts have noted that the IRS has a general responsibility to treat similarly situated taxpayers in a like manner. *Baker v. Commissioner*, 787 F.2d 637 (D.C. Cir. 1986) (noting that "[t]ax cases . . . are encompassed within the general concern that officialdom avoid arbitrary distinctions between like cases"); Ogiony v. Commissioner, 617 F.2d 14 (2d Cir.), *cert. denied*, 449 U.S. 900 (1980) (noting, in a concurring opinion, that "consistency over time and uniformity of treatment among taxpayers are proper benchmarks from which to judge IRS actions").

example, new churches (and their affiliates) that wish to have a group exemption might raise Constitutional issues, arguing that churches with existing group exemptions are receiving more favorable treatment from the government in violation of the Establishment Clause.

Transition Issues — The ACT believes that if group exemptions were eliminated, the transition period would be extremely difficult and disruptive for all stakeholders, including group ruling holders, their subordinate organizations, the IRS, and donors. Indeed, any process transitioning hundreds of thousands of organizations from one regulatory regime to another could not be otherwise.[10]

If group rulings were eliminated, there are several things that could be done to make the transition somewhat easier. For example, former subordinate organizations filing individual exemption applications could be permitted to file a shortened or abbreviated Form 1023 or Form 1024. (On the other hand, we note that a shortened or abbreviated application would necessarily provide less insight into the organization's operations and activities.) All applications from members of the same former group could be sent to the same team of reviewers at the IRS's Cincinnati Service Center, which would reduce the instances of similarly situated organizations receiving inconsistent treatment. Also, establishing a special, lower user fee or imposing the user fee on a group basis, could reduce the cost of filing exemption applications for subordinate organizations.

To address its own processing issues, the IRS could develop a system for phasing in (e.g., over a period of 3-5 years) the filing of exemption applications by former subordinate organizations. For example, entities could be required to come in with their former group members, based on the parent's employer identification number, location of the parent entity, or first letter of the parent's name.

But many other challenges would remain. The IRS's recent experience with the Form 990-N and the automatic revocation process suggests that it would have to commit a significant amount of its limited resources to outreach and education about the elimination of group rulings. Certain internal systems changes and additional staff in Cincinnati may be needed to accommodate the huge influx of exemption applications. And all

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[10] At the very least, the 250,000 existing section 501(c)(3) subordinate organizations would have to file Forms 1023 if group exemptions were eliminated. In addition, members of church group rulings that are not themselves churches, integrated auxiliaries, or conventions or associations of churches will have to file Forms 1023. Also, while entities exempt under other subsections of section 501(c) will not have to file exemption applications for federal tax purposes, any such organization whose state tax exemption is derived from its federal group exemption would have to file at the federal level and then at the state level to retain its state tax-exempt status. Thus, conservatively, we believe that as many as 300,000 or more new exemption applications would be filed with the IRS and require processing if group rulings were eliminated.

Treasury regulations relating to group exemptions would have to be amended (e.g., Treasury Regulations sections 1.508-1(a)(3)(i)(c), 1.6033-1(d), 1.6033-2(d), 1.6043-3(b)(6), 301.6104(a)-1(a), 301.6104(d)-1(f), and 601.201(n)(8)).

It is also very likely that donors will be confused about the status of a subordinate organization during the transition period. Because subordinate organizations have never been listed on Publication 78, we anticipate that donors will have trouble distinguishing between those group members that have lost their exemption for failing to comply with the new group ruling rules, and those which are still exempt under the old group ruling rules because they are still in the transition process.

In summary, the ACT believes that group exemptions should be retained because they significantly lessen the administrative burden on the IRS and group ruling members, they provide an additional level of oversight that would not be present otherwise, and they insure consistent treatment of similarly situated entities. We do recognize that, to some degree, there would be more transparency, accountability, and responsibility if there were no group rulings. But we believe the benefits gained by eliminating group rulings would not justify an incredibly difficult and disruptive transition process for all involved. Instead, as we discuss below, we believe that these benefits can be largely achieved through smaller, more targeted reforms of the current group ruling procedures.

B. Do the current group exemption procedures adequately achieve the tax policy objectives of transparency, accountability and responsibility?

1. Transparency

The concept of transparency relates to the ability of stakeholders – including the IRS, the states, donors, members of the public – to have access to current information about exempt organizations. Ensuring transparency, including access of information to the public, has become one of the most fundamental underpinnings of the law and regulation of exempt organizations at the federal and state level. The ACT believes that there are three aspects of the current group exemption procedures that undermine transparency. The first relates to the ability to file group Form 990 returns. The Form 990 is the principal vehicle for achieving transparency with respect to exempt organizations.[11] Particularly since its redesign in 2008, the Form 990 requires all exempt organizations with a filing requirement to provide detailed information about their operations, activities in the U.S. and abroad, governance, compensation, transactions with related parties, and much, much more.

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[11] The ACT notes that the public disclosure of Forms 1023 and 1024 also provides for some level of transparency. However, because those forms are typically filed when organizations are newly formed and have little if any operating history, they are quickly out of date and lack the currency of the Form 990.

While the group exemption procedures do not change the filing requirements for central or subordinate organizations, Treasury Regulations section 1.6033-2(d) allows central organizations to file a group return on behalf of some or all subordinate organizations that elect to file on a group basis. The Form 990 instructions for filing group returns are complex, and make it difficult (and in some cases impossible) for a reader to determine whether individual subordinate organizations are fully compliant with the applicable rules governing their operations.

The lack of transparency associated with group returns clearly has the potential to impede IRS enforcement efforts, because the IRS cannot determine from a group return whether the individual subordinates are in compliance with all relevant tax law requirements. Moreover, the information provided to the ACT by NASCO members confirms that the states have significant difficulty using the information provided in group returns for state regulation and enforcement purposes. Group returns also deprive donors, the public, the media, and other stakeholders of information that, if available, might be important to them in making decisions about grants and contributions, and in gaining a better understanding of the activities, finances, compensation, and governance of the organizations.

The second impediment to transparency relates to the absence of any requirement that central organizations disclose information about the composition of the group, such as a listing of subordinate organizations covered by the group exemption. While most central organizations are required to provide this information to the IRS in an annual filing, there is no requirement for central organizations to make it available to the public, whether on request or otherwise. Also, there is no requirement for central organizations to disclose to the public or the IRS the procedures they follow to exercise on-going general supervision or control over their subordinate organizations. Such information would be of value to the IRS and the states in carrying out their regulatory and enforcement responsibilities, and would also be of interest to the public, the media, and other stakeholders.

The third impediment to transparency relates to the fact that section 501(c)(3) subordinate organizations covered by group exemptions are not listed on Publication 78. The listing, on Publication 78, of exempt organizations eligible to receive deductible charitable contributions provides an important source of transparency for potential donors (including individuals, corporations, grant-makers, and others) who want to confirm that a particular organization is indeed eligible. The IRS has enhanced the utility of Publication 78 to donors by including it on the IRS website in a searchable form, and for many donors the inability to find an organization's name on Publication 78 will result in denial of the contribution or grant. The IRS is aware of the problems that subordinate organizations have in establishing their eligibility to receive deductible charitable contributions, and it issued Publication 4573 partly for that reason. While there is no question that Publication 4573 is helpful in some cases, it has not solved the

problem. Church group ruling holders are particularly frustrated about the inability to convince some donors that their subordinate organizations are exempt under section 501(c)(3). The problem is further compounded for them because many of their subordinate organizations are also not listed on the EOBMF, a document that is also available on-line and can sometimes be used as an alternative vehicle for demonstrating charitable status to prospective donors.

2. Accountability and Responsibility

The concept of accountability relates to the obligation of exempt organizations to operate and use their resources in a manner consistent with their exempt status. Exempt organizations are expected to be accountable to their regulators, including the IRS and the states, as well as to donors and the public. The concept of responsibility is closely related to accountability, and refers to the obligation of exempt organizations to operate in a manner that is consistent with the requirements of their exempt status. Group exemptions fail to encourage the proper exercise of accountability and responsibility in two primary ways.

First, Revenue Procedure 80-27 does not define the level of on-going general supervision or control that a group ruling central organization is expected to exercise. Without such definition, there is likely to be confusion and inconsistency in the level of oversight exercised by central organizations. Second, as noted above, central organizations are not required to disclose, to the IRS, the states, or the public, the procedures they follow in exercising on-going general supervision or control. The absence of such a disclosure requirement makes it difficult to assess the extent to which central organizations are carrying out their responsibilities, or whether the potentially enhanced accountability and responsibility inherent in group exemptions are being achieved. In effect, the IRS has “deputized” central organizations as agents of the IRS, but it has done so without guidance, training, or oversight. In particular, there has been no education or outreach by the IRS to group ruling holders to discuss what constitutes general supervision or control or what are the elements of “best practices” in this area, such as there has been in the past few years regarding governance of exempt organizations. All of these factors have combined to create a situation that is inconsistent with the growing trend in the tax-exempt community toward greater accountability and responsibility. It also creates an environment that can be abused by organizations included in group exemptions.

C. How can the current procedures be revised to enhance such tax policy objectives?

1. Eliminate Group Returns

Eliminating the group return option will greatly enhance transparency for subordinate organizations covered by group exemptions. It will make it easier for the IRS to assess compliance with applicable tax law requirements, and it will address most of the concerns that state regulators have with the group

exemption process. It will also make it possible for all stakeholders (the IRS, the states, donors, the media, and members of the public) to have access to the information required on Form 990 on an individual organization basis, which will be much more useful than the information provided on a group return. We do not believe that eliminating the group return option will significantly increase the Form 990 filing burden on subordinate organizations that formerly filed group returns, because the information required to be provided is the same – it is just the presentation that is different. And this would eliminate an administrative burden on the central organization because it would no longer be required to collect and present the information on a group basis.

2. Update Revenue Procedure 80-27

The ACT believes that the IRS should update Revenue Procedure 80-27. While we appreciate the challenges associated with this task, including the unique issues presented by church group exemptions, the ACT believes that Revenue Procedure 80-27 is no longer sufficient for its intended purpose. A key requirement of Revenue Procedure 80-27 is that the central organization have "general supervision or control" over the subordinate organizations, although that term is left undefined. We believe that the IRS should provide a definition, or at least a framework, for this concept, and we offer some suggestions below. We address this issue as it applies to churches separately, because it will be important for the IRS to develop special group exemption rules in that context. Also, given the large number of stakeholders in the group exemption process, we recommend that the IRS issue an updated version of Revenue Procedure 80-27 in proposed form, for public comment.

a. Define General Supervision or Control

i. In General

In developing a standard for general supervision or control to be exercised by central organizations in a group exemption, it is important to understand the purpose of having such a standard. It is not "supervision or control," *per se*, that is important. What is important is that the central organization has sufficient information about the on-going operations and activities of the subordinate organizations so that it may act to bring non-compliant subordinates into compliance, and if necessary, remove them from the group. The power to remove non-compliant organizations is sufficient leverage, in and of itself, to achieve this goal, provided the central organization has sufficient information about the subordinates. In other words, what is most important is that there are structural mechanisms, reporting processes, or a system of oversight that, on the whole, enables the central organization to sufficiently monitor each subordinate's activities.

One way that a central organization would have sufficient information about its subordinates is for the central organization to have control over the subordinate

organizations' boards or governing bodies. While this situation is probably not all that common in group exemptions, there is little doubt that such a central organization would be in a position to monitor the operations and activities of the subordinates.

But control over the boards or governing bodies of the subordinate organizations is not the only way to achieve the overall goal of the central organization having sufficient information about the subordinates. There are other facts and circumstances that would indicate a central organization is in a position to receive such information. The ACT believes that the IRS should include in a new Revenue Procedure a set of such factors indicating that a central organization is in such a position, i.e., that it is exercising general supervision or control over the subordinate organizations. The following are a list of possible factors that could form the basis of a standard for general supervision or control in group exemptions:

- The central organization appoints a board observer for the subordinate organization.
- The central organization has ownership rights over the property (including rights to the name or logo) of each subordinate organization or requires that the property of each subordinate organization be transferred to the central organization if the subordinate organization leaves or is removed from the group.
- Each subordinate organization has substantially similar articles, bylaws and/or corporate policies.
- The articles and bylaws of each subordinate organization must be approved by the central organization.
- Each subordinate organization must file reports with its central organization at least annually, providing information on basic governance, operations and finances.
- Each subordinate organization that is required to file an annual information return provides its central organization with a copy of the subordinate organization's Form 990, Form 990-EZ, or confirmation that the subordinate organization has filed a Form 990-N.
- Each subordinate organization provides its central organization with a copy of the subordinate organization's annual financial statements, if prepared.
- The central organization has audit rights over each subordinate organization and its operations.

- Significant funding is provided to/from the central organization from/to the subordinate organizations.
- Each subordinate organization has a well-publicized whistleblower policy, with the central organization being the recipient of any whistleblower complaints.
- Each subordinate organization must provide its articles and bylaws to its central organization, notify the central organization if the subordinate organization amends its articles or bylaws, and provide copies of any such amended articles or bylaws.
- Each subordinate organization must notify the central organization if the IRS or other governmental authority audits the subordinate organization.
- Each subordinate organization must notify the central organization if the subordinate organization receives a notice from the IRS or other governmental authority that the subordinate organization failed to file a required form or report, or if such form or report contained incorrect information.

As with any set of factors considered as part of a facts and circumstances test, not all factors are equally important, and a group should not be required to satisfy each factor. On the whole, however, each group must demonstrate adequate general supervision or control in the sense that the central organization has sufficient insight into each subordinate organization's operations and activities.

ii. Churches

The task of formulating an appropriate standard for general supervision or control for church group exemptions is particularly challenging.[12] There are potential Constitutional considerations and certainly practical ones.[13] Nonetheless, we believe there can be a workable standard for church group exemptions — a standard that balances the interests of churches of all polities in having group exemptions and the interests of the IRS in having sufficient transparency, accountability, and responsibility in group exemptions.

We believe there are two key considerations that should inform the development of a standard for general supervision or control for church group exemptions: (1)

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[12] It should be noted that several large church denominations, with tens of thousands of subordinate organizations, received their group exemption rulings prior to Revenue Procedure 68-13, i.e., *before* "general supervision or control" was first introduced as the standard.

[13] We are not Constitutional scholars, and hence, we will not address such matters in any detail in this report. But it is conceivable that the Establishment Clause could be implicated if the requirements to be eligible for the benefits of a group exemption unduly favor non-churches or churches, or some churches over other churches.

recognition that middle-level or "subunits" of a church, rather than just the central organization, can exercise the requisite level of supervision or control over the subordinate organizations, and (2) the requisite level of supervision or control over subordinate organizations should vary depending on the type of subordinate organizations (e.g., churches, integrated auxiliaries of a church, or other church-affiliated organizations).

General Supervision or Control by Subunits of the Church — As a testament to the autonomy granted by the First Amendment, churches are organized in a countless variety of ways, many of which do not fit into a conventional legal or corporate paradigm of supervision or control. At one end of the spectrum are purely hierarchical denominations where one entity has complete control over all the constituent entities of the church. At the other end of the spectrum are purely congregational denominations where the constituent entities share common beliefs, but otherwise operate independently of one another. And there are church polities that lie virtually everywhere between the two ends of this spectrum.

But the important point is the one noted earlier in the discussion of the ABA Exempt Organizations Committee's comments to the IRS regarding Revenue Procedure 80-27. Specifically, because of theological doctrine or practice, many church denominations are prohibited from having one central entity exercise supervision or control (in the conventional legal or corporate sense) over other entities within the denomination. Therefore, there should be another model for general supervision or control in the church group exemption context.

In many church group exemptions, the central organization is not always the "closest" church entity to the subordinate organizations. Instead, there are middle-level or regional "subunits" of the church that exercise more direct supervision or control over the subordinate organizations. For example, the middle-level church entities may own or have an interest in the property held by lower-level church entities. But more significantly, the middle-level entities (or their officials) may exercise religious or ecclesial supervision or control over lower-level church bodies and their leaders (i.e., clergy). And this type of supervision or control can be extremely powerful. Indeed, in some denominations, the clergy leadership of non-compliant subordinate organizations can be summarily removed from their positions by middle-level entities (or their officials) — even in the absence of any corporate board type of control over the subordinate organizations.

In summary, the ACT believes that the centralized, conventional legal or corporate model of general supervision or control simply does not work for church group exemptions. Middle-level entities or subunits of the church should be permitted to provide the requisite level of ongoing supervision or control over the subordinate organizations in church group exemptions. These subunits would then provide the central organization with the basic information necessary

for it to determine whether to remove a particular subordinate organization from the church group exemption.

General Supervision or Control that Varies Depending on the Type of Subordinate Organization — As noted earlier, there needs to be a balance between the interests of churches in having group exemptions and the interests of the IRS in ensuring sufficient transparency, accountability, and responsibility in group exemptions. We believe the best way to strike this balance for church group exemptions is for the requisite level of general supervision and control to vary depending on the type of subordinate organization. Specifically, we believe that there should not be any specified level of general supervision or control over subordinate organizations that are churches, integrated auxiliaries of churches, or conventions or associations of churches.[14] For other types of church-affiliated subordinate organizations, the requisite level of general supervision or control should be similar to the standard required for non-church group exemptions (with subunits of the church, rather than just the central organization, being permitted to exercise the requisite general supervision or control, as discussed above).

There are several reasons for applying this liberal standard for subordinate organizations that are churches, integrated auxiliaries of churches, or conventions or associations of churches. First, this standard would permit virtually all churches, even congregational churches, to have a group exemption covering these types of entities. Second, in many denominational group exemptions, individual local churches (for doctrinal reasons) and integrated auxiliaries (for financial reasons) typically already have a close, oversight-type of relationship with the central organization or some other subunit of the church. Finally, the IRS is not losing any transparency, accountability, or responsibility by having a more liberal standard for these types of subordinate organizations.

On this last point, one concern about section 501(c)(3) group exemptions is that the IRS is delegating to the central organization the determination of whether a given subordinate organization is indeed tax-exempt. But by statute, churches, integrated auxiliaries of churches, and conventions or associations of churches are not required to apply to the IRS for recognition of their exempt status. Also, there is the concern about ongoing monitoring of the operations and activities of subordinate organizations in group exemptions. But again, by statute, churches, integrated auxiliaries of churches, and conventions or associations of churches are not required to file annual information returns to the IRS. Thus, with respect to these types of organizations, the group exemption process does not deprive the IRS of any information it would otherwise have in the absence of group exemptions. Indeed, the application for the church group exemption provides the IRS with more information about these types of subordinate organizations than it

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[14] All subordinate organizations in a church group exemption should, however, satisfy an affiliation requirement, i.e., that they share "common religious bonds and convictions." (See IRC section 414(e)(3)(D) where this language is used to define association with a church in the context of church employee benefit plans.)

would have otherwise. The group exemption application provides the IRS insight into the structure, organization, and activities of the subordinate organizations, and assists the IRS in preventing abuse by organizations improperly claiming church status.

In summary, a liberal general supervision or control standard for subordinate organizations that are churches, integrated auxiliaries of churches, or conventions or associations of churches would permit virtually all types of churches to have group exemptions at little or no "cost" to the IRS in terms of losing transparency, accountability, and responsibility. Moreover, because these types of organizations do not file annual information returns, the ongoing oversight provided within the church group exemption is more than what the IRS would be able to do itself. Indeed, this additional level of oversight is one of the advantages of group exemptions, which can be particularly significant in the church context.

As for subordinate organizations other than churches, integrated auxiliaries of churches, or conventions or associations of churches, the calculus of balancing the interests of churches with the interests of the IRS is different. In the absence of group exemptions, many of these types of subordinate organizations would have to file individual applications for recognition of exemption. Thus, in this case, the IRS is deprived of some information about these organizations it would otherwise have in the absence of group exemptions. (On the other hand, some of these church-affiliated subordinate organizations that are not churches, integrated auxiliaries of churches, or conventions or associations of churches are required to file annual information returns.)

In balancing these interests, we believe that the standard for general supervision or control in church group exemptions with respect to subordinate organizations that are not churches, integrated auxiliaries of churches, or conventions or associations of churches should be similar to that for non-church group exemptions. However, because of the unique circumstances presented by church group exemptions, we recommend that the standard allow for consideration of additional facts and circumstances similar to those listed in Treasury Regulations section 1.6033-2(h)(2).

b. Exclude Type III Supporting Organizations

The ACT believes that Type III supporting organizations should be ineligible for inclusion in a group exemption, as is currently the case for private foundations. Changes made by the PPA make this an important issue, since it extended a new set of rules and restrictions on Type III supporting organizations, and on their donors, which are similar to some of the rules applicable to private foundations. Given these changes, donors need to know with certainty whether a particular organization is a Type III supporting organization and, if so, whether it is functionally integrated or non-functionally integrated. The ACT is concerned that the group exemption process does not lend itself to making these

determinations in a manner that is sufficient for donor reliance. We believe that in light of the PPA changes, the IRS's regulatory and enforcement interest in Type III supporting organizations warrants having them apply for recognition of their exemption on an individual basis.

c. Apply the Automatic 12-Month Extension Rule to Group Exemptions

As a technical matter, the ACT believes that sections 4.02.6 and 4.03 of Revenue Procedure 80-27 should be revised to incorporate the automatic 12-month extension rule that applies to organizations applying for recognition of exemption on an individual basis. *See* Treasury Regulations section 301.9100-2. This 12-month extension rule became applicable for individual exemption applications after the group exemption procedures were last revised in 1980. A conforming change should be made to the group exemption procedures.

3. Enhance Form 990 Disclosure for Central Organizations

To enhance transparency for group exemptions, the ACT recommends that all central organizations with some type of Form 990 filing requirement be required to file Form 990, even if they would otherwise be eligible to file Form 990-EZ or 990-N. Moreover, we recommend that all such central organizations be required to disclose, on Schedule O of the Form 990, information about the composition of the group and how the central organization exercises general supervision or control over the subordinate organizations. In addition, the IRS should consider requiring such central organizations to attach to their Form 990 a copy of their annual filing with the IRS that provides an update on the organizations added to and deleted from the group. While we understand that attachments to the Form 990 are disfavored, there would be an offsetting enhancement to transparency that should be taken into account.

4. Donor Reliance

One of the principal concerns that many section 501(c)(3) group exemption holders have is that their subordinate organizations are not listed on Publication 78. This is a frustration for donors as well, since many donors (particularly foundations and corporations) have become reliant on Publication 78 to confirm that prospective donees are eligible to receive charitable contributions. We understand that the IRS has a long-standing policy of including only the central organization, and not subordinate organizations, on Publication 78 and is committed to this position for a variety of reasons. For example, we understand there is concern that the public would assume subordinate organizations appearing on Publication 78 had been granted recognition of exemption by the IRS as part of the Form 1023 application process, rather than under the group exemption procedures. Also, there is a concern that an organization removed from Publication 78 because the central organization deleted it from a group exemption could bring a legal action against the IRS. In addition, there are

concerns with the ability to timely update Publication 78 to reflect additions and deletions of subordinate organizations. And finally, modifying the IRS's computer systems to restructure Publication 78 would involve significant logistical hurdles.

Notwithstanding the IRS's genuine concerns and difficulties, the ACT believes that the inclusion of section 501(c)(3) subordinate organizations on Publication 78 would further the goals of transparency and make it possible for a variety of stakeholders readily to confirm the exempt status of subordinate organizations. Publication 78 is intended, first and foremost, as a service to donors to facilitate the making of contributions to qualified section 501(c)(3) organizations. The fact that donors lack this service with respect to more than 250,000 section 501(c)(3) organizations (not counting 100,000 – 150,000 churches) that have recognition of exemption under the group exemption procedures is a source of concern to subordinate organizations and their donors. We understand that this is a source of concern to the IRS as well, which is one reason it issued Publication 4573. But group exemption holders have told the ACT that while Publication 4573 is helpful in some cases, it is not sufficient to address the problem.

If it is not possible to include subordinate organizations on Publication 78, the ACT recommends that the IRS work with affected organizations to consider additional ways to enhance the reliance by donors on the section 501(c)(3) status of subordinate organizations covered by group exemptions. Possible options might include the following:

(1) Make sure that all church group exemption holders are aware that the IRS will input and update information about their subordinate organizations on the EOBMF if that information is provided in the required format. Work with churches that are interested in this option to develop a process for obtaining and inputting such information.

(2) Have a separate "group exemption" page on the IRS website that includes a list of central organizations and their subordinates (to the extent the IRS has such information) with an explanation that the subordinates received recognition of exemption under the group exemption procedures and confirmation that donors can rely on such exemption. Also include an explanation of how donors may search the EOBMF for names of subordinate organizations, and explain that in the case of subordinate organizations under church group exemptions, they may not be included on the EOBMF.

(3) Include a list of the names and contact information (including Internet address) of central organizations on a separate "group exemption" page of the IRS website, with an explanation of the group exemption procedures and confirmation that donors may rely on information they receive from the central organizations as to the exempt status of their subordinate organizations.

VII. Recommendations

The ACT believes that group exemptions should be retained, but that the current group exemption procedures could be revised to achieve greater transparency, accountability and responsibility. Our recommendations may be summarized as follows:

1. Allowing group exemption holders to file group Form 990 returns does not provide the IRS, the states, or the public with adequate transparency about the activities of subordinate organizations covered by a group exemption, or serve as a mechanism to promote adequate accountability by the subordinate organizations on an individual basis. We recommend eliminating group returns by amending Treasury Regulations section 1.6033-2(d) to remove the authority of central organizations to file group returns.

2. Revenue Procedure 80-27 does not define or explain how central organizations are expected to exercise on-going general supervision or control over their subordinate organizations. This lack of guidance makes it difficult for group exemption holders to exercise appropriate responsibility with respect to their subordinate organizations and creates a lack of accountability in meeting unstated and unknown expectations. We recommend updating Revenue Procedure 80-27 to provide such guidance and that the revision be issued in proposed form for public comment. As part of this process, special consideration should be given to the development of appropriate standards to address the varied organizational structures and unique legal status of churches.

3. Group exemption holders are not required to disclose to the public their list of subordinate organizations or any other information about the composition of the group. Nor are they required to disclose to the public or the IRS the procedures they follow to exercise on-going general supervision or control in compliance with Revenue Procedure 80-27. This disclosure vacuum contributes to a lack of transparency and accountability with respect to group exemption holders. We recommend requiring group exemption holders that have a Form 990 filing requirement to disclose, on Schedule O of the Form 990, information about the composition of the group and how the central organization exercises general supervision or control. To ensure that all groups provide this disclosure, we recommend that each central organization with a Form 990 filing requirement be required to file Form 990, even if it would otherwise be eligible to file Form 990-EZ or 990-N.

4. While section 501(c)(3) subordinate organizations covered by group exemptions are generally listed in the Exempt Organizations Business Master File (EOBMF), they are not listed in Publication 78, making it impossible for donors to verify readily the ability of section 501(c)(3) subordinate organizations to receive tax-deductible charitable contributions. Recent IRS efforts to educate donors about their ability to rely on group exemption confirmations given by the central organization, while appreciated by the sector,

have met with mixed success at best. We recommend that the IRS work with section 501(c)(3) group exemption holders, including churches, to develop workable new options for including subordinate organizations in Publication 78 or otherwise providing donors with additional information regarding the deductibility of contributions that exists for other tax-exempt charities.

5. Changes made by the PPA in the definitions and tax laws governing section 509(a)(3) supporting organizations raise a question as to whether it continues to be appropriate for them to be included in a group exemption ruling. On balance, we believe that "Type III" supporting organizations should not be included in a group exemption ruling. We recommend that this be addressed as part of a project to issue an updated version of Revenue Procedure 80-27 for public comment.

6. Finally, we recommend that there be a significant transition period for existing groups to come into compliance with any changes to the group ruling procedures. Moreover, special consideration should be given to existing church group exemptions, as they are some of the largest and oldest of all group exemptions. (Some church group exemptions have tens of thousands of subordinate organizations and some have been in place for 60 years or more.) We recommend the IRS seek comment from existing group exemption holders before setting any time limits for a transition period.

ADVISORY COMMITTEE ON
TAX EXEMPT AND GOVERNMENT ENTITIES
(ACT)

Employee Plans:
Recommendations Regarding Pension Outreach to the Small Business Community

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Table of Contents

I. INTRODUCTION

A. Retirement Plans and the Small Business Community

The Internal Revenue Service (IRS) has the power to regulate retirement plans that are "qualified" under §401(a) of the Internal Revenue Code of 1986 (the "Code"), as amended,[1] as such plans are considered to be tax-exempt entities. The Employee Plans (EP) office within the IRS's Tax Exempt and Government Entities (TE/GE) division regulates these plans, both nationally and regionally through its six offices. While the IRS has authored numerous publications, both available in hard copy and online, regarding the establishment, maintenance and correction of retirement plans, the ACT undertook to evaluate the IRS's current outreach approach to small business stakeholders (e.g., small employers, providers, record keepers, payroll administrators, auditors, and related trade organizations and associations) and to make recommendations regarding those outreach efforts. Our goal is to approach this effort holistically so that it could transcend the small business community and then be applied by the IRS to other types of plan sponsors.

Small businesses employ more than half of all American workers.[2] However, only 25.8% of employees at businesses with fewer than 25 employees participate in an employer-sponsored retirement plan, compared to 45.9% of employees at businesses with 25 to 99 employees and 63.6% of employees at businesses with 100 or more employees.[3] For micro-businesses (those with fewer than 10 employees), the probability of the business maintaining a §401(k) plan drops to 10%.[4] Thus, a significant number of small business employees must rely solely on Social Security and personal savings to provide for their retirement.

While retirement plan participation among small businesses increased between 1990 and 2000, it has since declined. Hence, the number of employees participating in employer-provided retirement plans is considerably lower for businesses with 100 or fewer employees.[5] For those for-profit small businesses that do provide retirement plans to their employees, they typically do so through defined contribution plans in the form of profit sharing and §401(k) plans.

In this report, the ACT has not defined the universe of "small businesses." According to the Small Business Act which created the Small Business Administration (SBA), unless authorized by statute, federal agencies or departments may not prescribe a size standard to categorize a business as a small business unless such standard complies with certain criteria and is approved by the administrator of the SBA. The SBA uses numerical definitions (referred to as size standards) in ascertaining which

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1 All section references herein are to such Code unless otherwise indicated.

2 U.S. Small Business Administration, Office of Advocacy, available at www.sba.gov/advocacy/7495.

3 Congressional Research Service Reports: Pension Sponsorship and Participation: Summary of Recent Trends. John J. Topoleski, Analyst in Income Security (Sept. 11, 2009).

4 *See* Jules H. Lichtenstein, "Saving for Retirement: A Look at Small Business Owners," Office of Advocacy, U.S. Small Business Administration (March 2010).

5 *Id*.

businesses are eligible for several of its programs. For example, the Small Business/Self Employed division (SB/SE) of the IRS defines small businesses as those with $10 million or less of assets. However, in EP's world, plans with fewer than 100 participants are treated as small employer plans for purposes of filing Form 5500-SF (Short Form Annual Return/Report of Small Benefit Plan). Thus, there is no generic definition of the term "small business."

Tax expenditures extended to qualified retirement plans are one of the largest items in Treasury's annual budget, yet it is clear that the small business community is not fully utilizing the tax savings available through such expenditures, to the detriment of a significant group of employees. The reasons for this are diverse: retirement plans are complex agreements; the contracts between service providers[6] and small business adopters are novel to small business owners; the individual/entity who sold the plan and related adoption agreement to the employer may have little future contact with the small business owner; the small business owner is unaware of the responsibilities it is assuming under the plan and the terms of its agreement (if any) with the service provider; and there is often a lack of in-house personnel whose job it is to oversee the plan. What is apparent to the employee benefits practitioner community is that a small business typically is not guided by legal professionals at the time it establishes its plan (to review adoption agreements, plan documents, service provider agreements) or during the maintenance of the plan, to assure continued compliance, until the IRS, on audit, or the employer's auditor or service provider determines that the plan or its administration is out of compliance.

B. Description of Constituent Agencies

There are various federal agencies that specifically service the small business community. The SBA was created by Congress in 1953 to specifically aid, counsel and assist small businesses. The SBA has an extensive network of field offices and partners with public and private organizations. Some of its programs include "How to Start a Business" and "Sample Business Plan."

SB/SE likewise services the small business community and hosts an SB/SE Tax Center, providing access to tax information for small businesses. While SB/SE has a limited workforce that specifically works with small businesses, it leverages with numerous organizations to assist small businesses in avoiding IRS audits and achieving tax compliance. It also conducts phone forums and webinars and prepares articles. Questions posted by SB/SE customers through its phone-lines are answered and posted on the SB/SE website.

The U.S. Department of Labor (DOL) has undertaken a variety of educational outreach campaigns, including sponsoring programs on the importance of retirement

[6] Service providers include third party administrators who administer the retirement plan; record keepers that house participant data used by the retirement plan; and outside consultants and practitioners that advise the small business owner. The types of services rendered by these service providers not only vary depending on the breadth of services provided, but also as to the quality of such services.

savings, fiduciary issues, and health coverage.[7] The 1997 SAVER legislation mandated the DOL to engage in outreach to the small business community. Working with the SBA, Chambers of Commerce, and IRS, the DOL produced a publication entitled "Choosing a Retirement Solution for Your Small Business" (Publication 3998) that can be presented in person or via video, to assist small businesses in selecting the proper type of retirement plan. The DOL's Office of Small and Disadvantaged Business Utilization maintains a small business resource center to assist the small business community in understanding the rules and regulations that the DOL administers. More recently, the DOL partnered with local chambers of commerce in its fiduciary education campaign, holding workshops and webcasts, rotating between the DOL Regional Offices.[8] Targeted publications were designed and put online.

EP of course has its own outreach program to the small business community—this program is discussed more fully below.

C. Summary of Report's Objectives and Structure

The very first ACT report, issued in June 2002, contained a recommendation that EP Customer Education & Outreach (CE&O) focus its efforts on small employers who establish and maintain retirement plans. After almost ten years of such outreach efforts, this ACT report is intended to provide EP with feedback regarding those efforts and to make recommendations for future outreach endeavors.

The goals of the ACT's current report are four:

- to evaluate the TE/GE current outreach approach to small business stakeholders regarding the establishment and maintenance of, and correction of problems with, retirement plans maintained by that community and to make recommendations regarding these outreach efforts;

- to explore the creation of a clinic or expansion of an existing clinic's scope to assist small business owners who establish and maintain retirement plans;

- to partner with the Indian Tribal Government (ITG) and Exempt Organizations (EO) ACT subcommittees as they tailor outreach efforts to employers in those communities that maintain retirement plans, realizing that most members of those communities are small businesses; and

- to recommend changes to the current Employee Plans Compliance Resolution System (EPCRS) to make it easier for small businesses to self correct/voluntarily correct and to keep their retirement plans in compliance with Code requirements.

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[7] See the interactive website launched by the DOL and the American Institute of Certified Public Accountants (AICPA) designed to assist small businesses in deciding upon the appropriate retirement plan for their workforce, available at http://www.choosingaretirementsolution.org/.

[8] See *Getting It Right – Know Your Fiduciary Responsibilities*, available at http://www.dol.gov/ebsa/fiduciaryeducation.html.

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II. CURRENT TE/GE PROGRAM FOR OUTREACH TO THE SMALL BUSINESS RETIREMENT PLAN SPONSOR

A. Description of General IRS Approach

The home page of the IRS, www.irs.gov, provides a wealth of information to all the different communities it serves. To keep it from overwhelming visitors, the site continually divides and regroups information around different focal points to help visitors find the information for which they are looking. Currently, the IRS is making a concerted effort to reach small employers to inform them of the importance of retirement planning and the advantages of different types of tax-advantaged retirement savings vehicles.

A visitor will quickly find that links to the same information can be found by going down many different paths. The two main entries for a small business owner seeking information on retirement plans are the "Businesses" tab and the "Retirement Plans Community (RPC)" tab.[9] Both will provide the visitor with roughly the same information, but the RPC tab does it more elegantly with a powerful guide called the Retirement Plans Navigator, which is described more fully in Section II.B below.

A comparison of the two tabs, likely to appeal to a small business owner, illustrates how the IRS reframes and repurposes material, through different prisms in order to help people who process information differently, to eventually find the information they want. A small business owner focused on business issues is likely to choose the Businesses tab. That broad category is immediately divided into Corporations, International Business, Partnerships, and SB/SE. If the visitor selects the SB/SE tab, he or she will arrive at the Small Business/Self-Employed Tax Center that is described as offering one-stop assistance for many business operations, including "Starting, Operating or Closing a Business." The brief description under that broad heading does not mention retirement plans, but clicking two more links will bring the visitor to a page devoted to retirement plans with direct links to: the Small Business Retirement Plan Resources[10] (Why start a plan, choosing a plan, and what to do once your plan is in place); Retirement Plans Navigator (Web guide for choosing a retirement plan, maintaining it and correcting plan errors); Types of Retirement Plans (Starting and maintaining specific types of plans); Have you had your check up this year? for Retirement Plans (Get a one-page checklist of questions for your specific plan to see if you meet the basic operating requirements); Correcting Plan Errors (Tips on how to find, fix, and avoid common mistakes in retirement plans); Retirement Plan Audits ((Information on preparing for a retirement plan audit); Retirement News for Employers (Practical retirement plan information for plan sponsors); and Additional Resources for the Plan Sponsor/Employer (forms and publications, FAQs, customer account services, related government links, and an

[9] There are five additional tabs on the www.irs.gov home page — Individuals, Charities & Non-Profits, Governmental Entities, Tax Professionals and Tax Exempt Bonds Community.

[10] Available at www.irs.gov/retirement/sponsor/article/0,,id=237400,00.html.

overview of the Employee Plans office).[11] The visitor could have found much the same information if he or she reviewed the Small Business/Self-Employed Topics on the Small Business/Self-Employed Tax Center web page and selected "More Topics" that offers a link to Small Business Retirement Resources.[12]

The RPC web page has a narrower focus than the Businesses web page, but the challenge is to find information that meets the special needs of the small employer subgroup. To address that need, in 2009, the IRS launched the Retirement Plans Navigator. Although it can be used by plan sponsors of all sizes,[13] it is particularly useful to small employers who are less likely to seek the services of a benefits practitioner because of the expense involved. The Navigator helps to fill the void by using technology to lead a retirement plans novice through basic information on retirement plans and compliance. It also serves as a valuable tool for return visitors looking to quickly access information on compliance issues. The Navigator is described in more detail in Section II.B.

The RPC web page otherwise operates similarly to the Businesses web page by providing a variety of access points to information on retirement plans, except that the RPC page is probably easier to use because its subject matter is more focused. For example, in addition to highlighting the Navigator, the RPC page provides 16 other links on retirement plan topics[14] whereas the opening page under the Businesses tab has over 40 links to general business topics.[15] Having both approaches is useful even though each will eventually provide a visitor with most of the same material. The Businesses tab is more likely to attract a small employer who goes to the site looking for general business information directed at small employers, but may find his interest piqued by references to material on retirement planning. A small business owner may not think of herself as part of a Retirement Plans Community, particularly if she has not established a plan. If the Businesses tab did not include information on retirement planning, the business-oriented visitor might not develop an interest in retirement planning as quickly. Small employers who have a retirement plan or are considering establishing a plan will appreciate the efficiency and resources easily accessed from the RPC tab.

As mentioned elsewhere in this report, both approaches provide a wealth of good information, so much in fact that it may be overwhelming without a guided tour. Too much information can foster indecision rather that action. Not all small employers need or want sophisticated plans, at least immediately. Bells and whistles, or a more challenging plan type, can always be adopted later after a small employer has some experience with setting up and running a retirement plan.

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11 Available at www.irs.gov/retirement/sponsor/index.html.

12 Available at www.irs.gov/businesses/small/topic/index.html.

13 The description of the Retirement Plans Navigator on the RPC web page describes its advantages without reference to plan size ("Web guide for choosing a retirement plan, maintaining it and correcting errors," available at www.irs.gov/retirement/index.html). However, the Navigator web page characterizes it as "an easy retirement plan guide for small employers," available at www.retirementplans.irs.gov.

14 Available at www.irs.gov/retirement/index.html.

15 Available at www.irs.gov/businesses/index.html.

See the ACT's suggestions for publicizing EP's resources, described in detail in Section V.

B. Web-based Tools Available to Small Business Retirement Plan Sponsors

1. Retirement Plans Navigator

To reach the Retirement Plans Navigator, a visitor must go to a site that is related to www.irs.gov but not part of its standard website. The arrangement allows the IRS to work around the technological limitations of the standard IRS website that otherwise would limit the Navigator's flexibility. Once at the new site, the visitor is told that the Navigator provides "an easy retirement plan guide for small employers."

The Navigator path opens with a short PDF file titled *Lots of Benefits When You Set Up a Retirement Plan.*[16] It lays out the reasons why an employer should give serious consideration to establishing a retirement plan for the owner and the employees. From there, the Navigator provides information and additional links that lead the visitor through a list of the major plan types, moving from the simpler, more basic payroll-based IRAs through different types of defined benefit plans. There is also a link to a comprehensive side-by-side comparison chart for people who prefer their information in that form.[17]

The Navigator introduction also informs the visitor that the information is divided into three main categories—choosing a plan, maintaining a plan, and correcting errors. The list moves from the simple to the more complex plan type, starting with IRA plans, moving through §401(k) and profit-sharing plans and ending with defined benefit plans. If the visitor clicks on any of the options for the IRA-based plans, a one-page explanation pops up that summarizes the option's key characteristics and provides details on issues and correction methods. Each topic has additional links that allow the visitor to learn more about increasingly narrow issues that may be relevant to the visitor's situation.

The built in flexibility of the Navigator is useful for reaching out to small business owners because they do not easily fit into a uniform profile. The smallest business owners may simply want to ensure that they select a tax-efficient savings vehicle for their eventual retirement. They are likely to link to *Lots of Benefits* to see if a retirement plan makes sense for them, hit the link to the Plan Comparison Table, for an easy review of the major plan types, and quickly decide to concentrate on plans with IRAs or one of the simpler varieties of retirement savings. Another small business owner who is a high earning professional may be looking for ways to maximize tax deferral and is willing to take on the challenges of a defined benefit plan. Although they have different goals, each should appreciate information tailored to the small employer's

[16] Available at www.retirementplans.irs.gov/assets/28/Lots_of_benefits_pub.pdf.

[17] Available at www.retirementplans.irs.gov/plan-comparison-table.

perspective that is generally more user-friendly for that audience and easily available using the Navigator. Compare, for example, the comprehensive information offered in IRS Publication 560, *Retirement Plans for Small Business* on simplified employee pensions (SEPs)[18] or information from the standard site on SEPs[19] with the customized brochure provided on a Navigator link developed in conjunction with the DOL.[20]

The crossover between standard and customized information works fairly well, but at times the transition from colorful, easy-to-read brochures to the institutional web page style can be disorienting.

2. Widgets

Another web-based tool that can facilitate the search for information by a small business owner, and his or her employees, is a widget -- a portable on-screen tool that can be embedded almost anywhere online (for instance -- on social media networks or an employer's website) to get the word out on important tax issues. The IRS currently offers 12 varieties of widgets on tax-related topics.[21] The current roster covers adopting a child, changes in health reimbursement plan coverage, the earned income tax credit, health insurance for small business owners, buying bonds with tax refunds, and retirement plans. The retirement plans widget gives immediate access to visitors on non-IRS sites to the Retirement Plans Navigator tool, which then leads them to the information and resources on retirement plans available through www.irs.gov.

The appeal of the Navigator widget is its ability to leverage the usefulness of all the publications, guides, and other resources available on the RPC web page. A small business owner who may not be comfortable explaining how retirement plans operate to his or her employees could embed the Navigator widget on the employer's website and encourage employees to explore relevant topics. A plan service provider could install the Navigator widget on the provider's website so it would be easily available at any time, and at no cost, to clients seeking more information on a retirement plan topic. A trade association might encourage retirement planning among its members by making the information accessible through the Navigator widget readily available to its members on the association website.

C. List of Publications and Guides Available to Small Business Retirement Plan Sponsors

Visitors to www.irs.gov can find a complete listing of retirement plan forms/publications/products.[22] This compilation is comprehensive rather than

[18] Available at www.irs.gov/pub/irs-pdf/p560.pdf.

[19] Available at www.irs.gov/retirement/article/0,,id=111419,00.html.

[20] Available at www.dol.gov/ebsa/pdf/IRSpub4333.pdf.

[21] Available at www.marketingexpress.irs.gov/mexpress/widgets.

[22] Available at www.irs.gov/retirement/article/0,,id=96763,00.html.

inviting, but the more colorful, nontechnical publications can also be found on more user-friendly pages on the IRS website as an "additional resource." The publications of particular interest to small employers include *Retirement Plans for Small Business (SEP, SIMPLE and Qualified Plans); Individual Retirement Arrangements (IRAs); Choosing A Retirement Solution for Your Small Business*; Checklists for SIMPLE IRA Plans, SEPs, SARSEPs, §401(k) Plans, and §403(b) Plans; *SEP Retirement Plans for Small Businesses*; *SIMPLE IRA Plans for Small Businesses*; *SARSEPs for Small Businesses*; *Payroll Deduction IRAs for Small Businesses*; *§401(k) Plans for Small Businesses; Profit Sharing Plans for Small Businesses*;. and *Automatic Enrollment §401(k) Plans for Small Businesses*.[23] In addition, the IRS offers the following no-cost outreach vehicles for plan sponsors:

- Retirement plans phone forums.[24] Recent topics covered include in-plan Roth rollovers, hybrid plans, and fixing SIMPLE IRA and SEP plan mistakes.

- Webinars geared to the small business owner.[25] A recent example is the April 2011 presentation by Mark F. O'Donnell, Director, Customer Education & Outreach, TE/GE on "Easy, Low Cost Ways to Start Your Small Business Retirement Plan."

- Employee plan videos.[26] These were produced by EP to provide information to sponsors on choosing and operating plans. Sample topics: Self-Correcting Plan Mistakes; Fixing Plan Mistakes Found During an IRS Audit; Increasing Your Retirement Savings; Managing Your IRA; Starting a SEP or SIMPLE IRA Plan; The Navigator—Navigating Employer Information on Retirement Plans.

The *Retirement News for Employers* is directed more generally to employers of all sizes, but the IRS also has a bi-weekly *e-News for Small Businesses* available free online. It provides updates on tax requirements and links to other tax-related information on www.irs.gov to small business owners.

NOTE: Appendix B contains a list of current Outreach resources and activities.

[23] All publications are available at www.irs.gov/retirement/article/0,,id=96763,00.html.

[24] Available at www.irs.gov/retirement/article/0,,id=218995,00.html.

[25] Available at www.irs.gov/retirement/article/0,,id=125038,00.html.

[26] Available at www.stayexempt.irs.gov/ep/.

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III. ACT REPORT SURVEYS

A. Purpose of Surveys

In order to collect primary information on small business plans in connection with the preparation of this report, the ACT EP Subcommittee members decided to survey both practitioners/providers who work with small employers as well as the small businesses themselves. The volunteer members of the ACT carried out or conducted the surveys, not the IRS. The surveys were conducted for informational purposes only and have assisted the ACT in making recommendations to the IRS, described in Section IV below, about how it can enhance its relationship with small employers and the compliance efforts of their retirement plans.

B. Surveys

At the request of the ACT, the surveys were sent to five organizations that represent small business and service providers with the request that they forward the appropriate survey to their members or their email lists.[27] The organizations the ACT requested to disseminate the surveys are the American Society of Pension Professionals and Actuaries ("ASPPA"), the Profit Sharing/§401(k) Council of America ("PSCA"), the Small Business Council of America and the U.S. Chamber of Commerce. The ACT is not able to verify which, if any, of these organizations actually distributed the surveys to their respective membership lists. In addition, the ACT posted links to the surveys to approximately 15 different LinkedIn (social media) discussion groups that focuse on employee benefit issues and, primarily, count service-providers among their membership. Lastly, Benefitslink.com and PlanSponsor.com, two websites focused on the employee benefits community, promoted and distributed the survey to members on their respective mailing lists.

The ACT received 142 responses from providers, and 16 responses from small business owners. Since there were so few responses from small business owners, the ACT does not believe that the survey results from small business owners provide any meaningful information. However, even though the 142 responses by providers may not be representative or a significant number, given the total number of providers, the ACT nonetheless believes that the responses do provide information which the IRS may find useful. Responses to the Provider Survey can be found in Section III.C below. Copies of the survey results are set out in Appendix C.

C. Survey Results

The majority of respondents to the Provider Survey were consultants (56.0%) followed by attorneys (19.1%) and bundled service providers (15.6%).[28] The most popular type of retirement plan by far, for which they provide services, is a §401(k)

[27] Please note that the surveys do not represent a scientific sampling of providers or business owners. Rather, they were sent to organizations with which ACT members had contacts.

[28] All percentages were determined based on the number of responses received for each question unless otherwise noted.

plan, with 95.0% of all providers stating that they handled these plans. Tied in second place were money purchase plans and defined benefit plans (62.4% each), followed by §403(b) plans (48.9%), SIMPLE IRA/§401(k) plans (26.2%), SEP plans (22.7%), and other plans (32.6%). Providers advised a large number of plans, with 32.1% servicing 501 or more plans, 38.6% servicing 51-500, 20.0% servicing 11-50, and 9.3% servicing 1-10 plans. Thus, providers appear to be mainly large organizations advising small businesses sponsoring §401(k) plans, money purchase plans, and defined benefit plans.

Almost all (95.7%) of the providers currently use the IRS EP Web pages and 36.6% also used the IRS Retirement Plans Navigator website. Only 11.8% of the providers responded that they use the DOL and AICPA-sponsored "Choosing a Retirement Solution." Thus, providers appear to regularly utilize the IRS websites, especially the IRS Employee Plans Web pages.

Most providers (89.6%) refer their clients to the IRS EP Web pages for information. Only 37.5% refer clients to the IRS Retirement Plans Navigator website and only 20.8% to the DOL/AICPA website "Choosing a Retirement Solution." The most referred to non-government website was benefitslink.com (94.8%). Many used non-government websites such as ASPPA.com (72.4%) and plansponsor.com (62.9%), with some responders indicating that they use the American Benefits Council (23.3%), Investment Company Institute (14.7%), AICPA (13.8%), Society HR Management (7.8%) and other sites.

Providers indicated that, when they go to a government sponsored website, they are mostly looking for information on how to correct plan errors (73.9%), issues related to determination, opinion and advisory letters (54.3%), examinations (35.9%), types of plans (19.8%) and other information (34.8%). When asked to name two educational organizations that they used, most named ASPPA (56.6%). The National Institute of Pension Administrators (NIPA), SunGard, and ALI-ABA received a handful of mentions.

With respect to social media, providers most often used LinkedIn (72.1%), then Facebook or Message Board (14.0% each), Twitter (9.3%), Blog (7.0%) and a variety of other media (30.2%).

When asked about how providers assist their clients with plan documentation, most responded that they assisted in preparing summary plan descriptions (86.0%) and summaries of material modifications (81.3%). Almost 75% of the providers assist clients with volume submitter documents, 64.5% with master/prototype documents, and only 46.7% with individually designed plans. Almost all, 91.7%, complete the plan documentation for their clients, 83.3% follow up and confirm if their clients have completed all legally required paperwork and 95.5% provide updates (such as plan amendments). Of the updates, 56.3% adopt them automatically for their clients.

Almost 75% of the providers perform Code limit testing (e.g., maximum deferral, maximum contribution, etc.). They also perform the following Code non-

discrimination testing: top heavy determinations (96.3%), ADP/ACP testing (93.8%), coverage testing (92.6%), general nondiscrimination testing (91.4%), and compensation ratio testing (75.3%). In most cases, the provider identifies the highly compensated employees and key employees based on census data provided by the client (73.8%) and manages any needed correction process (71.0%), while the client manages this process in 20.0% of the cases. Twenty-two percent of the providers are involved in the correction process but work with either the client's third party administrator, record keeper, or other advisor.

Providers supply the following notices and government filings to their clients: safe harbor auto enrollment (81.2%), Forms 5500, signature ready (79.2%), summary annual reports (78.2%), qualified default investment alternative notices (60.4%), Forms 5300 (59.4%), determination letter packages, signature ready (59.4%), PBGC filings (42.6%), sample Forms 5500 (8.9%) and sample determination letter packages (8.9%). With respect to Forms 5500, only 50% of the providers replied that they review plan census and financial information to determine the appropriate responses on the form, while 13% replied that they require their clients to provide all of the responses; 9% stated that it was a collaborative process.

Approximately 75% of the providers also assist their clients with corrections using EPCRS while 25% refer their clients to an attorney. When asked if they thought the requirement to submit certain voluntary corrections to the IRS affects their clients' decisions to correct, 44.7% responded that they thought the requirement discourages correction; 28.2% indicated it encourages correction, and 27.2% said the requirement has no impact. However, when asked if their clients would be more or less likely to correct problems that currently require a submission if they could do so without a formal IRS submission, 83.8% responded that their clients would be more likely to correct, 1.9% less likely and 14.3% no impact. Only 56.6% stated that their clients would be more likely to correct if they were required to inform the IRS of the correction but not request approval, 16.2% less likely and 27.3% no impact.

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IV. OVERVIEW OF RECOMMENDATIONS

The five following sections of the ACT report set out a number of recommendations geared toward better educating the small employer retirement community on retirement plan design and compliance, as well as providing small employers with additional tools and assistance so they can better comply with IRS requirements imposed on their retirement plans. For example, the report makes detailed recommendations designed to make current EP small employer retirement plan resources more visible. The report also suggests the creation of new small employer tools that can acquaint small employers with issues from choosing the right type of retirement plan to issues involved in terminating a plan a small employer has already adopted. The report also suggests ways in which current IRS technology related to small employer plan resources on the EP website can be improved.

The report also recommends that the IRS consider partnering with law schools and/or benefit practitioner groups to create a retirement plan clinic geared to small employer needs. Ideally, the clinic would provide “hands on” assistance to small employers in helping them deal with problems they are currently encountering with their retirement plans. The report also suggests several changes to EPCRS that are designed to continue to make this IRS correction program easier to and friendlier for use by small employers. Finally, the report makes several recommendations as to how the current IRS examinations and determination letter programs can be tweaked to be more responsive to the reality of the world in which the small employer stakeholder lives—a world which includes their working with vendors and service providers who simply cannot provide these small employers with services that are commensurate with their needs, given the small amount of assets typically involved in a small employer retirement plan.

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V. OUTREACH SUGGESTIONS

A. Introduction

The ACT has reached out to representatives of many constituencies who play a role in the small business retirement plan community to obtain their perspective on EP's outreach efforts. (A list of these representatives is attached as Appendix A to this report.) These constituencies include EP's CE&O staff, trade associations whose members provide services to small plans, other agencies interacting with small businesses, such as the DOL and SBA, and, via the survey methodology described above in Section III.B to actuarial, accounting, consulting, and third party administrators, service providers and small businesses themselves. The recommendations in this Section V are the result from these efforts.

B. Publicizing Employee Plans Resources

While many of the ACT EP Subcommittee members regularly work with small business plan sponsors, we were consistently impressed by the amount and quality of the EP resources currently made available to the small business community, many of which we were not aware. Our initial impression was that many of these excellent resources, such as the Retirement Plans Navigator (www.retirementsplans.irs.gov), could go a long way in addressing the needs of the small business consumer, but that a key issue, for the IRS to tackle, is the fact that many small business owners do not know these resources are available. This impression was validated by our interactions with the small business retirement plan community, many of whom were not aware of these significant resources. Going forward, we recommend that these resources be expanded in the following ways:

1. Internal Revenue Service Website

   We recognize that EP's website represents only a portion of the IRS.gov platform and that, within the IRS, the technical aspects of IRS.gov are not within EP's control. While there is relatively high recognition of the EP website and comments from those with whom we spoke were positive, we recommend that additional efforts to create a small business specific resource page on EP's website be pursued -- one that is easily accessed by a descriptive link (e.g., http://www.irs.gov/smallbusiness). This link would likely refer to the Navigator, would refer to related resources from the DOL, as noted below, and would provide some information on the additional resources suggested in item V.C below. As a preliminary, perhaps simpler step, it would be helpful to put a direct link to the Retirement Plans Navigator on the SB/SE page where it is more likely to catch the attention of a small employer browsing through the other available tax information.

   Also, when reviewing the SB/SE web page, we noticed that there is little information, other than health care reform information, on this page addressing small business retirement plans. Adding an easily-found and seen link to

retirement plan information on the SB/SE website would also facilitate the dissemination of further knowledge to the small business community, especially to the accounting and financial staff who may turn to the IRS website for information on other tax reporting issues. Lastly, to further highlight these issues, we recommend that the IRS work on embedding this new link in other materials as they are revised, such as publications and EP forms relevant to small businesses.

2. Ancillary EP Websites

As already mentioned and as discussed further below, we recognize that there are technological limitations that limit EP's ability to enhance the existing website. We recognize that EP has already made substantial efforts to work around the potential limitations through the creation of IRS-related sites technically independent from the main IRS website. Probably the best example of these creative efforts is the Retirement Plans Navigator.

The Navigator website is an outstanding tool that could use further visibility. Members of the ACT and many of those with whom we spoke to in the benefits community were not aware of this tool until directed to it by members of EP. It is the lack of knowledge of this excellent tool that is our concern. As with our recommendations with respect to a new small business EP Web page, we recommend making the Navigator, which has value for all sizes of plans, not just small employer plans, more visible in IRS presentations, in required disclosures where possible, and in forms. We believe this will enhance its use and further reinforce EP's substantial customer-focused efforts.

In addition, to the extent resources permit further expansion of the Navigator, we suggest leveraging the Navigator platform to address a number of additional issues. We understand that, because of the technological nature of the website, it is highly flexible. As such, although currently established as a small business-oriented website that provides a significant amount of information in a good form, we recommend that it be reviewed and expanded so that the underlying information embodied in the site might be further customized for other market segments in the EP area through the use of different skins (i.e., cover interfaces on top of the same technological platforms), such as one for the plans of Indian Tribal Governments. Perhaps, "mini-Navigators" featuring plans that are most likely to create a successful experience for two or three identifiable categories of small businesses could be created. For example, these might include a seasonal micro-business operating out of the owner's home; a small business with 25 to 50 employees, mostly young, but with relatively secure positions; and a more mature small business with middle-aged employees starting to worry about their retirements. Whether or not this expansion is under the "Navigator" moniker, we strongly encourage the continued use and publicizing of these ancillary websites.

3. Leveraging Other Government Agencies

Throughout our interviews, we spoke to representatives from numerous federal agencies in addition to the IRS. While it is commendable that the IRS and DOL have established a very strong relationship in the customer education and outreach area, we believe there are a number of other groups that should continue to be actively involved in IRS small business outreach. We therefore make the following recommendations:

First, we encourage the continued coordination with the DOL on publications, and encourage EP to work to increase joint outreach efforts with the DOL. Potential examples include more joint presentations (or tandem presentations if more feasible due to internal approval processes), coordination of resources between both agencies' websites so that there is clear linkage of small business efforts between both agencies,[29] and potentially archiving joint or tandem presentation materials and recordings for a "one stop" resource for small businesses. Integrating the role of the DOL more seamlessly into explanations of the regulatory scheme should raise the comfort level of small employers. Two totally distinct regulators with different compliance requirements and potential penalties can be intimidating to a retirement plan novice.

Second, the IRS should continue to work to find synergies with the SBA which has significant "on the ground" personnel who could help to expand knowledge of EP's small business resources. We recognize that there are concerns about having another person or entity acting on behalf of the IRS, so we would recommend creating stock templates and presentations that, along with the materials suggested for the small business Web page, could be used to provide the SBA with a toolkit.[30]

Third, the IRS should look to other government agencies that have contact with small businesses, ranging from the Social Security Administration to state unemployment departments to provide them the toolkit of materials described above and to work with them to publicize the IRS's small business retirement plan resources.

4. Potential Private Sector Partners

Outside the context of governmental agencies, there are a number of potential private sector partnerships that could expand the visibility of EP's resources for small businesses. As reflected in our survey results discussed in Section III.C, service providers play a key role in the implementation and administration of small business retirement plans. These service providers range from accountants, to attorneys, to actuaries, to "bundled service providers," to record keepers and third party administrators. Recognizing the roles these

[29] From a small business perspective, it is often not clear where the IRS's role ends and the DOL's begins.

[30] The toolkit is described further in Section V.C.1 below.

intermediaries play, there are a number of ways that they can be enlisted to expand EP's outreach.

First, there are other community organizations, such as various chambers of commerce and boards of trade, which have significant interaction with all portions of the small business community. These organizations are likely to have far more resources than EP and could, using a toolkit, serve as an extension of EP's CE&O function.

Second, many of the service providers we contacted have ongoing direct contact with small business retirement plan sponsors. These providers should be enlisted to highlight the resources for small business retirement plan sponsors that are available from EP. This assistance can be encouraged in a number of ways, including the following:

- Service providers often provide newsletters and other communications to their small business clients and prospective clients. By educating and working with these providers to better understand the tools available to them from EP, these providers could then be used as a distribution channel for information about EP resources. In addition, because service providers often spend significant resources to prepare these materials, to the extent that EP can enhance its partnership with them, they may be encouraged to use EP materials (as already and as might be created pursuant to the recommendations made in Section V.C) to reduce their operational costs. This value-added option should be emphasized to the service provider community as part of EP's outreach efforts.

- Service providers regularly provide seminars and other presentations to their small business clients and prospective clients. Training them on the toolkit described below could further enhance small employer knowledge of EP and its resources.

- Because of its role in regulating significant aspects of the prototype and volume submitter tax-qualified plans and prototype IRA-based plans that are the dominant form of plan document used in the small business community, and because of the oversight authority inherent in the IRS Enrolled Retirement Plan Agent (ERPA) certifications, we believe EP has the ability to require expanded communications to small business retirement plan sponsors. Examples of these communications and their implementation could include:

Service providers that use IRS IRA documents provided in the Form 5305 series could be required to provide additional disclosures regarding IRA plan establishment and duties relating to IRAs through the inclusion of these disclosures as part of the model document. Non-model providers could also be directed regarding required disclosures in a future update of the IRS's IRA

prototype program procedures currently reflected in Revenue Procedure 2010-48.[31]

We also recommend that EP coordinate with the DOL to create similar materials listing common fiduciary duties and a checklist of whom, such as the plan sponsor, provider or other advisor, is responsible for carrying out these duties.

A fundamental assumption of these recommendations is that EP will be able to connect with various community organizations and service providers. With respect to community organizations, we anticipate that the governmental outreach partners described in Section V.B.3 above could assist with this process. With respect to service providers, we assume that the IRS could leverage off of its records of IRA sponsors who have utilized its prototype approval program, Form 5498 filings, and its lists of prototype and volume submitter sponsors. We therefore believe that EP already has significant information available to it about potential outreach partners.

C. Additional Tools

1. Outreach Toolkit

In Section V.B.3, we recommended that EP prepare a presentation toolkit to assist in its outreach efforts. We anticipate this toolkit would focus on two key sets of information. First, the toolkit would contain model presentations that highlight EP's outreach priorities. We would encourage multiple models that address different focus areas, such as selecting a plan, maintaining a plan, and terminating a plan. To the extent that existing presentations and materials could be redesigned, we recommend this approach as an initial step. Second, the toolkit would contain additional resources targeting small business retirement plans. These items would be drawn from existing resources and some new resources, including possibly those listed in Section V.C.2 below.

2. Additional Materials

As noted at the beginning of this Section V, EP already has a significant amount of materials that can be helpful to the small business retirement plans community. We recommend that EP also consider the creation of the following which could be included on the suggested small business EP Web page:

- A periodically-updated list of upcoming deadlines, such as the deadline for adopting a new prototype plan document.
- Short checklists and interactive tools (such as for non-calendar year small businesses) for small businesses adopting, maintaining, or terminating a plan. As noted above, this list could, in coordination with the DOL, be expanded to address fiduciary duties.

[31] 2010-50 I.R.B. 828.

- An archive of questions asked by small business owners maintaining plans available through RetirementPlanQuestions@irs.gov.

- A simple interactive program to work through corrections. The EP Web pages already contain significant amounts of information about the corrections programs, but a simplified tool might be more helpful to small employers.

- As noted earlier in this report, EP currently makes "widgets" (self-contained computer codes to be included in other websites) that are designed to direct people to the EP website. In addition, because many service providers provide newsletters, email alerts, and seminars to their clients and prospective clients, the enhancement of existing IRS resources, such as the specialized websites described above and the "widgets" available to third parties to provide direct linkage to IRS online resources, is essential. We recommend that the IRS continue to work with its internal and external resources to expand the number and flexibility of widgets (such as by creating widgets that can prepare a streaming news feed from the EP website or focus on a specific market segment).

D. Technological Improvements

In this Section V, we have already noted that EP does not have control over the IRS website that is a key feature of EP's outreach. Because this website is not a "database driven" website, EP CE&O personnel spend significant amounts of time and resources having to regularly update Web pages rather than continuing their outreach efforts. The Navigator also relies on significant amounts of data that needs to be updated on an ongoing basis. Subject to resource ability, we recommend that the IRS look into implementing more "back end" solutions that allow for updating of one reference, for example, the increase in the Code §402(g) deferral limit for a given year, that will automatically carry through to all related Web pages. Making these improvements would allow CE&O staff to further enhance their outreach to the community as a whole rather than spending personnel time on manual website updates. This should also provide for further efficiency in these times of restricted financial resources.

VI. Possible TE/GE Initiative – Creation of a Retirement Plan Clinic Staffed by Volunteer Practitioners – An ACT Recommendation

A. Introduction

The ACT is recommending that EP partner with one or more existing clinics or create a clinic to address the needs of the small business community establishing and maintaining retirement plans.[32] While qualified plans (particularly §401(k) defined contribution plans) would be the initial focus of the clinic's outreach efforts, it could later be expanded to cover §403(b) plans, governmental plans, and qualified defined benefit plans maintained by small businesses and small entities.

B. Needs of Small Business Owners

We believe that the IRS's partnership with existing clinic(s) or the creation of a new clinic would solidify its outreach efforts to small business stakeholders regarding the establishment, maintenance, and compliance of retirement plans offered by small business owners to their employees. Because many of these owners currently establish retirement plans without the benefit of outside counsel, they are unaware of the responsibilities they are undertaking under such plans and unaware of the consequences of the terms of the service provider's contract (or the lack of such contract). Thus, small business owners do not understand what services to expect from a service provider, the fees to be charged for such services, and the resulting obligations should the service provider fail to deliver. In certain situations, service provider contracts are used as a shield by the service provider against liability caused by vague language and a sometimes opaque disclosure of fees. Therefore, we believe there is a real need to reach out to the small business community to help its constituents understand the terms of the plans they are adopting, to review service provider contracts (or point out the consequences of the absence of such contracts), and to identify responsibilities of the small business owner and the service provider.

While IRS educational products are extremely important and useful, they cannot replicate a one-on-one discussion with a small business owner as to its responsibilities as a plan sponsor and the allocation of responsibilities between the owner and the service provider pursuant to a service provider contract. Small business owners also are often not educated on the fiduciary[33] and ongoing compliance requirements related to keeping a plan qualified. Without a complete understanding of the obligations they are undertaking with the establishment of a

[32] The proposal to create a clinic to service small business owners was initially proposed by David Wray of the Profit Sharing/§401(k) Council of America and Ian Kopelman of DLP Piper LLP, in partnership with The John Marshall Law School's Center for Tax Law and Employee Benefits. As an outgrowth of discussions to involve more Americans in tax-qualified retirement plans, the suggested clinic's goal was to review contracts between service providers and small businesses establishing qualified defined contribution plans to determine compliance with the law and whether such contract provisions deliver expected services at clearly disclosed fees and set forth resulting obligations for provider underperformance.

[33] Fiduciary obligations under qualified plans involve elements of both Title I and II of ERISA and thus, coordination with the DOL may be necessary in this area.

qualified plan, small business owners are ill equipped to keep the plan in full compliance. Due to the vast number of such plans, it is a daunting task for the IRS to discover all the plans that are not in compliance and to direct them to its correction programs (e.g., the EPCRS.) When compliance issues arise under these plans, they often involve sizable corrections, necessitating the hiring of a practitioner to pursue correction.

C. Current Tax Clinics Presently Partnering with IRS

In its discussion with IRS personnel, the ACT discovered that the IRS currently partners with a variety of clinics. Some of these have been created through federal legislation and specifically funded through the IRS's budget. SPEC is an acronym for Stakeholder, Partnerships, Education, and Communication, and is an outreach and education unit within the IRS's Wage and Investment (W&I) division. SPEC oversees the Volunteer Income Tax Assistance (VITA) program, which services low to moderate income taxpayers who file individual income tax returns (Form 1040), and the Tax Counseling for the Elderly (TCE) program, specifically targeted for the elderly population. Under the SPEC model, the IRS uses a "leverage" approach whereby not-for-profit entities and educational institutions (including law schools and business schools) provide tax advice and assistance, with the IRS providing oversight and review functions. Last year, $12 million in grants were given to 180 partners in this endeavor. The IRS relies on its SPEC partners to carry malpractice insurance. SPEC presently uses 4,500 local partners over the entire United States, 360 coalitions with Code §501(c)(3) partners, and over 80,000 volunteers. The IRS provides the training materials; standards that are required for an entity to partner with the IRS; and quality review. SPEC has over 600 employees within the IRS.

In contrast, there is a taxpayer advocacy model, known as the Low Income Taxpayer Clinic (LITC), which provides representation for low income taxpayers in controversies with the IRS. LITC was created through federal statute (viz., Code §7226), and is authorized to provide matching federal grants (up to $100,000/year per clinic) to academically hosted clinics (e.g., law, business, or accounting schools) or not-for-profit entities (e.g., legal aid, legal service clinics). The clinic receiving the federal grant must match the grant through non-federally funded sources (e.g., charitable foundations). Students who handle tax controversies for low income taxpayers before the IRS must have a practice order from the Office of Professional Responsibility and must be supervised by an attorney or professor authorized to practice before the IRS. The students and clinical staff give legal advice, and the clinic sponsoring LITC therefore must have malpractice insurance covering the staff and student volunteers.

Given that there is specific legislative authority for the creation of VITA, TCE, and LITC, and that they involve federal grants from the IRS, they are not suitable models for the clinic the ACT is proposing in this report.

D. Two Spectrums and the In-Between

The proposal to create a new clinic or to expand the scope of an existing clinic could take on many different forms, depending on the extent of IRS involvement with the clinic. We considered two ends of a continuum that the IRS could consider in creating or partnering with an existing clinic:

- A clinic that provides *only* educational outreach information, using existing IRS publications and educational products. Such a clinic would certainly minimize the IRS's exposure to estoppels-like claims by taxpayers if incorrect advice is given, and reduce the cost of maintaining such a clinic. It could be staffed by *pro bono* practitioners and students with practice orders, subject to Circular 230, thus assuring the IRS, and its agents, that the information communicated would be reliable and timely.

  Content of the information provided through an educational clinic could include:

  (i) An overview of the types of qualified plans that could be adopted without any recommendation as to the type best suited for a specific employer;

  (ii) A list of responsibilities that the small business owner generally has under a typical §401(k) plan, and a list of services generally assumed by the service provider under typical service provider contracts, without reference to or review of actual service provider contracts that may have been entered into by the small business owner;

  (iii) A list of fees that are typically disclosed under typical service provider contracts, without any analysis of the reasonableness of such fees; and

  (iv) A discussion of the general correction principles used by the IRS to solve noncompliance issues.

- On the other end of the continuum, the clinic (either created by the IRS or an existing clinic that partners with the IRS) would provide one-on-one legal advice to the small business community on their qualified defined contribution plans on a wide number of issues:

  (i) Not only providing an overview of the various types of plans that a small business could adopt, but discussing the suitability of a particular plan for a particular business owner;

  (ii) Reviewing the actual terms of the business owner's retirement plan to assess the owner's actual responsibilities and to make the owner aware of the consequences of noncompliance with the Code's tax qualification rules;

  (iii) Reviewing the actual terms of the service provider contract (if any) related to the owner's plan to assess the responsibilities assumed by the owner and

service provider, and the resulting obligations of the service provider for non-performance;

(iv) Reviewing the actual terms of the service provider contract to determine the amount of fees assessed under the contract; and

(v) For plans which are noncompliant, assisting the owner with actual resolution of corrections through EPCRS.

From the small business owner's perspective, the ACT believes a clinic which provides one-on-one legal advice would be preferable to a clinic that provides only educational information. An "actual advice" clinic would undoubtedly lead to greater compliance by this segment of the population of retirement plans. However, we understand that the creation of a clinic or expansion of the scope of an existing clinic could take either of the two extremes described above, as well as anything in between, depending on the extent of the IRS' involvement with the clinic. Because the ACT is not in a position to ascertain the level of risk and/or extent of resources available to the IRS in creating such a clinic or assisting in the expansion of an existing clinic, we have highlighted below the issues that we believe the IRS should consider in fashioning a new, or modifying an existing, clinic. In Appendix D to this report, the ACT EP Subcommittee has outlined existing law school clinics that service the small business community, as well other not-for-profit clinics that cater to this community. If the IRS decides to partner with an existing clinic, it could explore expanding the scope of one of these clinics to deliver services regarding retirement plans maintained by the small business community.

In fashioning a new or modifying an existing clinic, the ACT recommends that the IRS consider the following questions:

- **Nature of the Information Provided:** Does the IRS envision that the clinic will provide educational resources only or actual legal advice on a variety of topics? Various topics could include retirement plans that could be adopted by the employer; the terms of the retirement plan adopted and associated liabilities of the employer in adopting such a plan for failure to comply with the applicable qualification requirements; responsibilities assumed by the employer and the service provider pursuant to the service provider contract (if any) and the resulting consequences for non-delivery of such services; the fees that the employer will be responsible for under the service provider contract; and, if the plan is noncompliant, how to resolve such issues – through self-correction or EPCRS. As is apparent from current IRS outreach efforts, sufficient educational information is available to small business owners, but not within the context of the actual plan and service provider contract that has been adopted. In a clinic, the IRS could consider the use of pre-approved and pre-screened checklists to assess existing plans and service provider contracts to assure greater objectivity and uniform results in providing the advice. The clinic could provide on-site videos describing the basic responsibilities of the various players (plan sponsor,

third party administrator, fiduciary) prior to the review of service provider contracts.[34]

- **Sponsorship or Advocacy:** Does the IRS wish to actually sponsor a clinic (e.g., fund, promote and extend reliance) or simply advocate the use, and expansion of the scope, of an existing clinic dedicated to small business owners? In either event, funding may have to be secured from private or government sources to reach small businesses in the context of retirement plans. How much control does the IRS want to exert over the clinic with respect to its administration?

- **Criteria for Employer Eligibility:** What criteria will be used to identify the type of small businesses that would be eligible for assistance from the clinic? It is envisioned that the clinic's clientele would be small businesses that otherwise did not have the financial resources to hire an attorney to resolve its retirement plan issues. However, determining eligibility criteria (e.g., size, financial revenue, sophistication) will be critical to successfully establishing a clinic.

- **Criteria for Plan Eligibility:** Would the clinic be limited to assisting small businesses with their qualified retirement plans, or could it extend to all types of retirement plans (§403(b) plans, §457 plans)? When many of the new welfare benefit rules affecting medical plans become effective in 2013, would the clinic service clients on resolution of problems with their medical plans?

- **Location and Time Involvement:** If the IRS were to create a new clinic dedicated to small business owners with retirement plans, how will it deal with the issue of housing the clinic? We recommend the establishment of a pilot program with a law school with strong ties to the employee benefits community. Such a pilot program could minimize the initial funding costs, and identify potential long-term costs with such a project, especially if it is expanded nationwide. Use of an existing clinic would eliminate this problem. The Legal Services Corporation (LSC) is funded by grants from the U.S. government to provide civil legal aid through the use of private *pro bono* attorneys. Expansion of an existing clinic funded through LSC, to include retirement plans maintained by small business owners, could be a viable alternative.

- **Staffing for the Clinic:** Does the IRS wish to staff the clinic with its personnel or use *pro bono* practitioners? Interaction with a *pro bono* employee benefits practitioner, in lieu of an IRS agent, would be designed to put small business owners at ease that their plans, that will not be targeted for audit, so that the small business community may be more likely to seek out such assistance. The ACT EP Subcommittee has engaged in discussions with McDermott Will & Emery regarding clinic staffing, and McDermott Will has agreed to dedicate its employee benefits practitioners in the cities of Chicago and Washington, D.C., to provide some of the necessary staffing.

[34] Reviewing such videos could perhaps be a requirement for a small business owner's receipt of assistance from an "actual advice" clinic.

Alternatively, the sponsorship of a clinic by employee benefit practitioners, drawn from a cadre of law firms, could be considered. Most large city local bar associations have an employee benefits committee that uses the resources of the bar association. Such resources could be used to create a small business owner clinic. Decisions as to the frequency in which the clinic is staffed (e.g., once a month, once a quarter, etc.) will also have to be addressed.

There are various groups that the IRS could also reach out to in staffing a small business retirement plan clinic (e.g., the American College of Employee Benefits Counsel, ASPPA, employee benefits committees of city and state bar associations, members of the employee benefits community that are subject to Circular 230, and the ABA Section of Taxation, Employee Benefits Committee).

- **Liability Insurance**: If the clinic is constructed in such a way as to provide actual legal advice to small business owners, what additional liability insurance should be provided for the *pro bono* practitioners? Alternatively, will such *pro bono* practitioners be relieved by statute from any liability associated with the provision of these services?

- **Reliance**: Would the IRS provide reliance to the small business owners provided with advice through the clinic? Would the IRS extend lower user fees for small business owners that correct compliance issues following the advice of the clinic's practitioners? Obviously, the reliance and reduced fees would make the clinics more popular and attractive to small business owners.

Until the IRS can internally resolve these issues, concrete proposals are difficult to make. However, noncompliance is a widespread problem for small business owners who lack the resources and funds needed to resolve these issues with the assistance of an employee benefits practitioner. Harnessing the resource of the *pro bono* employee benefit practitioner community, to effectively advise owners and steer them into compliance, would provide the IRS with an effective resource in assuring tax compliance.

E. One-Year Pilot Program

Based on the answers that the IRS provides to the above questions, the ACT recommends that any clinical program begin as a one-year pilot program through The John Marshall Law School in Chicago, IL. The John Marshall Law School hosts the only LL.M. in Employee Benefits in the nation and has 28 adjunct faculty members testing in the LL.M program, and 22 Advisory Board members. The school presently has 45 enrolled students seeking the LL.M. Employee Benefits degree who would be available to assist adjunct faculty, Advisory Board members and *pro bono* practitioners. Because the law school is located in Chicago, IL, it has a variety of practitioners practicing locally who serve on the Chicago Bar Association's Employee Benefits Committee, Illinois State Bar Association's Employee Benefits Section Council, and the Employee Benefits Committee of the American Bar Association's Section of Taxation; these practitioners could also be tapped to assist

in the clinic. In addition, McDermott Will & Emery has agreed to staff a one-year pilot program with employee benefits attorneys from its Chicago office.

The benefit of a one-year pilot program would be to start the program with an initial business plan that could then be changed as issues and problems are identified and resolved. The initial housing and funding issues would be resolved in the first year as The John Marshall Law School would house and supervise the clinical program. The law school has hosted a variety of clinical offerings, including the VITA Grant Program which provides assistance to low-income taxpayers in completing their annual 1040 tax forms. An adjunct faculty member could supervise that program, along with tax practitioners from the Chicago tax community and student volunteers who assist with the taxpayer in-take process.

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VII. FURTHER SIMPLIFYING THE EPCRS CORRECTION PROCESS FOR SMALL EMPLOYERS

Voluntary correction of qualified plan errors has made great strides since the IRS first introduced the concept in Revenue Procedure 98-22.[35] Each subsequent iteration, of this revenue procedure, has expanded and simplified the voluntary correction process. However, many small employers continue to view the correction of plan defects as a daunting process that will result in significant expense to engage an attorney or consultant to assist them. Therefore, the ACT recommends that the IRS continue to review EPCRS to identify further simplifications to facilitate greater voluntary compliance among the small business community.

A. Prior ACT EPCRS Recommendations (Not Limited to Small Businesses)[36]

1. Recommendations That Have Been Implemented

   a. Voluntary Correction Program (VCP)

      (i) Adopt a standardized application form for VCP to assist and expedite in the initial screening and review process to classify submissions as routine or complex.

      This recommendation was implemented with the addition of Appendix F in Rev. Proc. 2008-50.[37]

      (ii) Amend the VCP procedures to clearly permit the use of the DOL Online Calculator to calculate earnings adjustments.

      (iii) This recommendation was implemented in Section 6.02(5)(a) of Rev. Proc. 2008-50,[38] but only in situations in which it is not feasible to determine the actual rate of return.

   b. EPCRS in General

      (i) Improve education and outreach by reminding plan sponsors of compliance issues and by reaching out to nontraditional stakeholders (e.g., registered investment advisors) to enlist their assistance in promoting compliance among small employers.

      The IRS has expanded its education and outreach including the use of issue-specific Fix-It Guides and compliance checklists specifically targeted to small business plan sponsors. However, there are no similar tools targeted to nontraditional stakeholders.

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[35] 1998-1 C.B. 723.

[36] Unless otherwise noted, all recommendations were included in "Improving The Employee Plans Compliance Resolution System: A Roadmap for Greater Compliance" delivered by the ACT on June 11, 2008. Available at www.irs.gov/pub/irs-tege/tege_act_rpt7.pdf.

[37] 2008-35 I.R.B. §6.02(5)(a).

[38] *Id.*

(ii) Publish guidance on how to deal with operational deficiencies that do not violate a particular Code section.[39]

While this recommendation has been implemented with regard to certain failures (e.g., failure to implement a participant's deferral election), there are other failures that may call for similar guidance.

2. Recommendations That Have Not Been Implemented

a. Self-Correction Program (SCP)

(i) Expand the duration of the self-correction period for significant operational failures to an indefinite time period subject to certain conditions such as a requirement to complete correction within a specified time period following discovery of the failure.[40]

(ii) Expand the duration of the self-correction period for significant operational failures from the last day of the second plan year following the occurrence of the failure to the last day of the third plan year.

(iii) Expand the self-correction amendment options to include retroactive correction by amendment for scrivener's errors.

b. Voluntary Correction Program (VCP)

(i) Adopt a new program allowing plan sponsors to submit a notice to the IRS that a VCP submission is forthcoming so that, in the event of an interim examination, the plan sponsor will be treated as though a VCP submission had been filed.

(ii) Reform the VCP fee structure to make it fairer and encourage greater participation.

(iii) Amend the VCP rules to permit plan sponsors to file a qualified separate line of business correction in the event the plan sponsor fails to timely file the proper notice.

(iv) Amend the VCP procedures to permit correction of limited exclusive benefit failures (e.g., inadvertent receipt and retention by a plan sponsor of demutualization proceeds).

(v) Amend the VCP procedures, to permit a plan sponsor that is not otherwise entitled to use the DOL's delinquent filer program, to correct IRS Form 5500 filing failures.

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[39] Recommendation included in the report of the ACT delivered on June 21, 2002, available at http://www.irs.gov/pub/irs-tege/tege_act_rpt.pdf.

[40] *Id.*

c. Audit Closing Agreement Program (Audit CAP)

(i) Make information public, regarding the administration of Audit CAP, to facilitate better understanding of the resolution process.

(ii) Permit a plan sponsor to request an internal high-level reconsideration of proposed Audit CAP sanctions to improve consistency and fairness.

d. EPCRS in General

(i) Develop a revenue procedure to assist payors in reporting corrective distributions.

(ii) Expand EPCRS to include §457(b) plans.

(iii) Expand EPCRS to permit correction of section §403(b) plan document failures. Note: This expansion is currently in process.

(iv) Develop concepts and publish guidance for using the best available data for corrections when actual data is missing[41]

(v) Permit voluntary correction of form deficiencies in situations other than scrivener's errors if, over a specified period of time, the plan has been consistently administered in a fashion contrary to the plan language and the vast majority of disclosures to employees support the plan's administration.[42]

(vi) Encourage self-audit programs.[43]

B. Additional Recommendations to Simplify EPCRS for Small Employers

In addition to reiterating certain recommendations described above, the ACT makes several additional recommendations for the expansion and simplification of EPCRS for small employer plans. For purposes of these recommendations, the ACT considers a small employer plan to be one with 25 or fewer participants as of the first day of a particular plan year. Although these recommendations are made in the context of the small business plan universe, some of the recommendations could be considered for an expansion of the EPCRS program to all plans, regardless of size.

[41] *Id.*

[42] *Id.*

[43] *Id.*

1. Self-Correction Program (SCP)

   a. Create an online self correction tool for small employer plans.

      Anecdotal evidence suggests that many small employers do not self- correct because they are unsure of the proper means for doing so. They are reluctant to engage an attorney or consultant due to concerns that the professional fees may be disproportionate to the failure being corrected. The development of an online tool that guides small employers through certain self-correction processes would eliminate the hesitation that may otherwise exist and ensure that corrections are implemented and documented accurately and consistently across the small-employer community.

      There are several existing tools that may serve as models for such a system, depending on the level of detail desired. The DOL's Voluntary Fiduciary Compliance Program (VFCP) online calculator allows a plan sponsor to enter the amount of the transaction in question (e.g., delinquent employee deferrals and the relevant dates), and it calculates the amount of lost earnings to be deposited. Another model is the Form 990-N e-postcard system permitted for small tax-exempt organizations whose annual gross receipts are normally $50,000 or less.

   b. Expand the duration of the self-correction period for significant operational failures from the last day of the second plan year following the occurrence of the failure to at least the last day of the third plan year.

      It is not uncommon for small employers to discover operational failures only after an extended period of time has passed following an occurrence. The discovery may coincide with a change in service providers when there is a "fresh set of eyes" reviewing the plan, or perhaps the plan sponsor is receiving professional advice for the very first time. Such sponsors may be willing to correct the oversight while being reluctant to incur the time and expense associated with a formal submission via VCP. Expanding the SCP correction window, beyond the current two-year timeframe, would allow sponsors, in these situations, to make full correction without the detailed submission that would otherwise be required.

      The availability of the extended correction window could be subject to additional conditions, including:

      - The correction could be limited to certain enumerated operational failures and specific correction methods such as the one-to-one correction method for a failed ADP test.

      - The sponsor could be required to implement the correction within an established timeframe (e.g., 12 to 18 months), following discovery of the error.

- The sponsor could be required to notify (rather than seek approval from) the IRS of the correction via a postcard-type form. This could include an online notification as described above.

2. Voluntary Correction Program (VCP)

   a. Replace the current VCP approval process with a simplified post-correction filing and/or record retention requirement.

      The VCP approval process for failures eligible for correction, using Streamlined VCP set forth in Appendix F, should be further simplified for small employer plans by replacing it with a postcard-type notification, as described above, accompanied by a specific requirement that the plan sponsor retain, for an established period of time (e.g., through the end of the third year following the year in which correction is completed), all corrections records that would otherwise be required to be submitted in a Streamlined VCP application.

   b. Adopt a new program allowing plan sponsors to submit a notice to the IRS that a VCP submission is forthcoming so that in the event of an interim examination, the plan sponsor will be treated as though a VCP submission had been filed.

   c. Develop online VCP submissions.

      VCP submissions require significant documentation, much of which exists in electronic format (e.g. PDF) which must be printed and compiled prior to submission. On receipt by the IRS, these documents are logged, reviewed, and assigned for processing. The IRS has already taken steps to streamline the content of VCP submissions by adding Appendix F to Revenue Procedure 2008-50, and it has provided fillable PDF applications on its website. Developing a web-based submission mechanism would further streamline the process. Furthermore, requiring the electronic submission to follow a prescribed format could lead to expedited cataloging, tracking, and processing resulting in decreased processing and personnel costs. This functionality could be developed in partnership with private vendors similar to the development of the DOL's EFAST 2 system and the PBGC's MyPAA system. To encourage use of an electronic submission system, the required VCP fees could be discounted by some pre-set percentage.

3. EPCRS in general

   a. Expand the list of allowable corrections by retroactive plan amendment subject to nondiscrimination and anti-cutback requirements.

      Prior versions of EPCRS introduced the concept of sanctioned correction via retroactive plan amendment in certain limited circumstances including allowing an employee to make elective deferrals to a §401(k) plan prior to

entering the plan and operationally permitting hardship distributions contrary to the terms of the plan document. Furthermore, Treasury Regulation §1.401(a)(4)-11(g) allows retroactive plan amendments to correct nondiscrimination failures.

EPCRS should be expanded to permit correction by retroactive plan amendment as long as the amendment does not violate the anti-cutback provisions of Code §411(d)(6), and the additional benefits conferred do not discriminate against non-highly compensated employees. Examples of failures that may be correctable by retroactive plan amendment subject to these conditions include:

- Error: Plan sponsor of a §401(k) plan allocates a true-up matching contribution at the end of the year despite language in the plan document requiring that the match be determined on a pay period basis.

  Correction: Amend the plan to allow the true-up match.

- Error: Plan sponsor of a §401(k) plan makes a matching and/or nonelective contribution for all otherwise eligible participants although the document does not permit such contributions.

  Correction: Amend the plan to allow the matching and/or nonelective contribution.

- Error: Plan sponsor allocates a match and/or profit sharing contribution throughout the year despite the existence of a requirement that participants be employed on the last day of the plan year to share in the allocation.

  Correction: Amend the plan to remove the last-day condition.

- Error: Plan sponsor of a profit sharing plan allocates its contribution based on gross compensation despite plan language excluding bonus, commission, and overtime from the plan's definition of allocation compensation.

  Correction: Amend the plan to include bonus, commission, and overtime in the plan's definition of allocation compensation.

b. Publish guidance for using the best available data for corrections when actual data is missing.

Whether due to the purging of records, changing service providers, or a combination of these and other factors, actual data that may be required to correct a failure spanning multiple years may be unavailable. For example, a long-term, part-time employee is excluded from the profit-sharing plan. Ten years later, when the plan sponsor engages a new service provider, it is

discovered that, while part-time, the employee in question worked more than 1,000 hours each year and should have entered the plan. The plan sponsor is willing to make a corrective allocation on behalf of the employee,but only has payroll and contribution records going back seven years.

EPCRS should be expanded to include a safe harbor method for determining how to fill gaps in missing data. Using the above example, EPCRS could provide that compensation and contribution figures for the three years for which data is missing could be reasonably estimated by taking the average of the seven years of data that is available.

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VIII. OTHER PROGRAMS

A. Examinations

1. Role of Examinations

   Recognizing that small businesses are already wary of the IRS, we recommend that, at this stage in IRS efforts to increase communication with and compliance levels of small employer plans, audits be considered a last resort until the broader outreach effort suggested by this report is implemented. However, we recognize that enforcement must, at some point, be part of the process to ensure that employers of all sizes recognize that there are potential enforcement risks if they fail to follow through on their duties as sponsors and administrators of retirement plans.

2. Recommended Next Steps for Examinations

   We recommend that once a decision is made to put a comprehensive outreach strategy in place, one part of the strategy should be an up-front effort to lay out a roadmap of likely future EP examinations activity involving small employer retirement plans. While EP is not a revenue-focused part of the IRS, it is often viewed as such by members of the retirement plans community. Accordingly, it is essential that future EP examinations activities, related to small employer retirement plans, be clearly laid out so that the inherent skepticism in the community is proactively managed. The message could be communicated in the following steps:

   First, the IRS would indicate that there will be “soft” non-audit outreach pursuant to an Employee Plans Compliance Unit project. This project would focus on contacting small business retirement plan service providers to query about common failures and issues arising in connection with small employer plans. As discussed elsewhere in this report, we believe that the IRS should have the ability to connect with service providers because of its regulation of the model IRA documents, the prototype and volume submitter program, and the ERPA registration program. This soft, non-audit outreach could be conducted through surveys and other questionnaire methodologies.

   Second, the IRS could, from the lessons learned from these outreach efforts, turn to compliance checks and other soft outreach to small plan sponsors themselves. Any compliance check should be beta tested with small business retirement plan service providers, and, to the extent possible, volunteering small businesses, before widespread introduction. We would recommend that any such compliance checks be very short in nature and that simplified correction methods, as also discussed in this report, already be in place so as not to place too significant a burden on small employers. We would recommend not using the approach of auditing non-responsive small businesses that was used in connection with the 2010 §401(k) questionnaire.

Third, to the extent that there is future audit activity involving small employers themselves, the small business Web page recommended in Section V.B.1, should be updated to contain sample information document requests (IDRs) and detailed information on the audit process prior to the commencement of small employer audits. As suggested above with respect to compliance checks, these IDRs should be tested through external focus groups prior to implementation. Further, once implemented, a single managerial person in Examinations should be identified as a liaison whom small businesses under audit can contact in the event of confusion or other issues during the audit process.

Fourth, as suggested in Section VII.B, simplified EPCRS procedures should already be in place at the time of audits to permit expedient and non-burdensome corrections pursuant to Audit CAP of items discovered on audit.

B. Volume Submitter and Preapproved Determination Letters

1. Require Circular 230 practitioners to sign-off on completed adoption agreements as a condition of their opinion/advisory letters

   We recommend that, in order to facilitate greater recognition of the importance of the plan document as a foundation for the plan's establishment and ongoing compliance, sponsors of pre-approved plans be required to obtain a sign off by a Circular 230 practitioner on each completed document to certify that its form is compliant. This requirement would be a condition of the sponsors' opinion/advisory letter and would help to ensure that appropriate care and diligence is used in drafting documents, and that a professional, possessing the requisite skill and expertise, reviews the form of the document. Furthermore, the requirement of such a review may serve to highlight especially complex provisions so that plan sponsors may be educated as to the implications and associated responsibilities.

2. Require sponsors of pre-approved documents to submit a list of adopting employers to IRS on some periodic basis as a condition of their opinion/advisory letters

   A majority of qualified plans now use pre-approved plan documents, and these plan sponsors are seldom, if ever, required to submit their documents to the IRS for individual determination letters. As a result, the IRS is unable to collect accurate statistics as to the number and types of plans in existence from one year to the next. In addition, certain small employer plans may never be required to file a Form 5500 series return, making it much less likely the IRS will ever capture meaningful data on those plans. We recommend that, as a further condition of a pre-approved document sponsor's opinion/advisory letter, each such sponsor be required to submit to the IRS, on a periodic basis, a list of all employers who have adopted one of the sponsor's pre-approved documents along with such other basic information the IRS may determine to be relevant. Additional information may include type of plan, type of pre-approved plan

document, adopting employer contact information and, potentially, the existence of certain plan features.

3. Require sponsors of pre-approved plans to distribute certain required information (e.g., a list of required services), as a condition of their opinion/advisory letters

   Prototype and volume submitter tax-qualified plan sponsors, desiring to receive an opinion letter from the IRS on their plan documents, could be required to provide basic information on plan maintenance duties, such as plan amendments, annual testing requirements, and annual information return requirements, to small businesses adopting their documents before documents are executed, and to obtain and retain acknowledgement of review of such information from each purchasing employer. This information could be required to be provided and acknowledged on a periodic basis. We strongly recommend that this information be kept simple so that it would be distributable, if in paper form, in one or two pages. Electronic distribution should also be encouraged and permitted. Because most providers currently image their executed documents, we anticipate that requiring the obtaining and retention of a periodic acknowledgement, like that described above, would only impose a minimal regulatory burden. We also expect that the only significant penalty that would be imposed on a service provider or plan sponsor, for failing to obtain and retain this acknowledgement, would be the loss of a favorable opinion letter (with retroactive reliance and transition relief provided to small employers so as not to penalize them).

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IX. IRS Retirement Plan Outreach Efforts to Small Indian Tribal Government/Business Employers and to Small Tax-Exempt Organizations

A. Indian Tribal Governments

Due to recent legislation distinguishing between Indian tribal governmental and non-governmental functions, the Indian tribal employer community as a whole faces a significant challenge in determining the appropriate type of retirement plan to be adopted by a particular employer, as well as in understanding the Code rules that apply to a particular type of plan (particularly when the special rules that apply to governmental plans are factored into the analysis). During the past year, the members of the ITG subcommittee of the ACT consulted with the ACT EP subcommittee members with a view to identifying the retirement plan issues which are of primary importance to the ITG employer community. The ITG subcommittee's separate report contained herein lists these issues.

We urge EP to use this issues list to develop meaningful retirement plan guidance for the ITG employer community, many of which are small employers. It is hoped that the development of a primer on ITG employer retirement plan issues (from plan selection to plan maintenance) will be part of that guidance.

B. Tax-Exempt Organizations

A significant portion of the tax-exempt organization employer community consists of small employers. These employers are of course entirely funded through donations from the general public and possibly from grants from foundations and federal, state and local governments. These employers do not have a product to sell. Mission and, in the case of religious nonprofits, ministry are the focus of their fundraising efforts, and, after the needs of mission and ministry are satisfied, the typical small tax-exempt employer cobbles together a benefit program as best it can to try to meet the particular needs of its workers—many of whom often serve in a "quasi-volunteer" capacity.

Many of these small tax-exempt employers maintain §403(b) plans or arrangements. When §403(b) annuities were added to the Code in 1958, the annuities offered were individual annuities purchased from insurance companies, with the employer typically serving as a conduit for passing participant contributions on to the insurance company annuity provider. Over time, mutual fund complexes and church denominational retirement programs also became permitted §403(b) providers, and individual annuities morphed into group annuities and eventually into §403(b) "plans."

However, as this evolution occurred, one thing remained constant—employers typically did not themselves take on §403(b) compliance responsibility, instead leaving compliance to the §403(b) providers. These providers, while they may have done their best to assist with §403(b) compliance, faced a problem unique to the §403(b) world—an employer that contributes to one §403(b) vendor might also be contributing (or have contributed in the past) to another §403(b) vendor (or even

vendors) on behalf of the same participant—and §403(b) compliance is required on an “aggregate” or “across all vendor contracts” basis.

It was into this §403(b) world that the IRS ventured in 2003 when it published a comprehensive set of proposed §403(b) regulations that were a significant re-write of the then existing regulations. These proposed regulations became final on January 1, 2009. The final §403(b) regulations basically turned the §403(b) world on its head. The final regulations made it clear that it was the employer’s responsibility for §403(b) compliance and not the §403(b) vendors (unless a vendor agrees to act as the employer’s designee for that purpose). Not surprisingly, a measure of chaos ensued. Today, the §403(b) marketplace continues to attempt to adjust to the new world of §403(b)—and, again not surprisingly, small tax-exempt employers are the most stressed in terms of knowing to whom they can turn for assistance with the new §403(b) reality.

EP has recognized this state of affairs and commendably has in a very public way tried to reassure the §403(b) community that it will apply a softer, gentler audit touch while tax-exempt employers and §403(b) vendors alike install the processes and systems that are needed for compliance. In addition, the IRS has mounted an aggressive educational campaign for §403(b) employers and should be equally commended for devoting substantial resources to that effort.

EP will also soon (hopefully) issue a revenue procedure opening up the availability of prototype opinion letters and volume submitter advisory letters for §403(b) plans prepared by vendors. It is the hope of the IRS and the §403(b) practitioner community that many (perhaps most) small tax-exempt employers will adopt pre-approved §403(b) plans. However, unless §403(b) vendors and service providers provide more robust compliance assistance to these small tax-exempt employers than has been provided in the past, noncompliance will continue to be a major problem.

EP is also in the process of updating EPCRS to incorporate correction methods and procedures for §403(b) violations. This will be a much needed and, we believe, much used feature of EPCRS in the future, and many of the same suggestions that were made earlier in this report to improve EPCRS for the small employer apply equally (perhaps in spades) to the small tax-exempt employer.

Much is thus being done for the §403(b) community and much of what is being done has been and will continue to be of great value to small tax-exempt employers. However, the ACT wants to emphasize a point that has been made to IRS representatives over and over by the §403(b) practitioner community—it took 40 years for the pre-2009 state of affairs regarding §403(b) compliance to develop, and it will take a number of years (though certainly not 40) for that state of affairs to be completely changed. The key to §403(b) compliance for the small tax-exempt employer will in the end be much the same as that for the small for-profit employer—securing meaningful compliance assistance from the §403(b) vendors who are selling them §403(b) products. To the extent the IRS can encourage or require that compliance assistance be provided by these vendors, the small employer tax-exempt community will be much the better for it.

X. CONCLUSION

This report contains an important theme—that of partnership. Small employers simply do not have the resources to employ the expertise that is needed to insure that their retirement plans are maintained in a manner that complies with complex Code requirements. The IRS cannot by itself be that resource—that is not its function. The ACT believes that there are a number of groups and agencies with which the IRS can partner to provide that expertise. Whether it is with other federal or state and local agencies (e.g., the DOL or the SBA), law, accounting or benefit consulting firms, benefit practitioner groups (e.g., the American Counsel of Employee Benefits Counsel, ASPPA or local bar associations or regional benefit associations around the country), or even with the service providers to the small employer retirement plan community, the ACT believes that effective partnerships can be formed to better educate and provide assistance to small businesses in America.

However, partnership is not the only theme of this report—there is much the IRS can do on its own to improve its outreach to the small business retirement plan community. The report suggests several ways in which the IRS can expand the retirement plan resources that are available to small businesses and make those resources more visible to them. The report also suggests ways in which the EPCRS program, which already has been revised to make it easier for small employers to utilize the program, can be made even more user friendly and accessible to small businesses. Finally, the report suggests ways in which the EP Examinations and Determination Letter programs can be revised to reflect the reality of the small business retirement plan environment—in the case of the latter program, by requiring service providers and vendors who earn a profit from selling retirement plan products to small businesses to take a measure of responsibility for ensuring the ongoing compliance of such plans with Code requirements.

Small businesses are an important and vital component of the American economy. The IRS has already done much to reach out to small businesses with respect to their retirement plan needs. Through partnering with the practitioner community, the ACT believes that even more can be accomplished in the years ahead.

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Appendix A:
Government and Professional Participants

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Government personnel (in alphabetical order)

- Michael Birdsong, Federal Intergovernmental Partnering Program Manager, SB/SE Communication and Liaison
- Michael Beebe, Acting Director, SPEC Headquarters Operation
- Anita Bower, Tax Law Specialist, TE/GE Employee Plans Customer Education & Outreach
- Robert Choi, Director, TE/GE Employee Plans
- Amelia Dalton, National Relationship Manager, W&I Stakeholder Partnership Education & Communication (SPEC)
- Greg Ford, Chief of National Partnerships, W&I Stakeholder Partnership Education & Communication (SPEC)
- Debra Golding, Deputy Director, Education and Outreach, U.S. Department of Labor, Employee Benefits Security Administration
- Joseph Grant, Acting Commissioner, TE/GE
- Sarah Hall Ingram, Commissioner, TE/GE
- Cindy Jones, Acting Chief, Oversight and Analysis, W&I Stakeholders Partnerships, Education & Communications (SPEC)
- Michael Julianelle, Former Director, TE/GE Employee Plans
- Joyce Kahn, Manager, Technical Guidance and Quality Assurance, TE/GE Employee Plans Rulings & Agreement
- Janet Mak, Acting Manager, Voluntary Compliance, TE/GE Employee Plans Rulings & Agreement
- Michael McBride, Acting Director, W&I Stakeholder Partnership Education & Communication (SPEC)
- Rhonda Migdail, Acting Manager, TE/GE Employee Plans Rulings & Agreement
- Gretchen Mitterer, Manager, SB/SE Communication and Liaison
- William P. Nelson, Director, Low Income Taxpayer Clinic (LITC)
- Mark O'Donnell, Director, TE/GE Employee Plans Customer Education & Outreach

- Karin Old, Internal Revenue Agent, TE/GE Employee Plans Customer Education & Outreach
- Melaney Partner, Manager, SB/SE Communication and Liaison
- Nancy Payne, Internal Revenue Agent, TE/GE Employee Plans Customer Education & Outreach
- Martin Pippins, Manager, Voluntary Compliance, TE/GE Employee Plans Rulings & Agreement
- Kim Prince, Senior Tax Analyst, W&I Stakeholder Partnerships, Education & Communications (SPEC)
- John Schmidt, Staff Assistant, TE/GE Employee Plans Customer Education & Outreach
- Ron Smith, Chief of Strategic Planning, W&I Stakeholder Partnerships, Education & Communications (SPEC)
- Monika Templeman, Director, TE/GE Employee Plans Examinations
- Seth Tievsky, Senior Technical Advisor to the Director, TE/GE Employee Plans Rulings & Agreement
- Ester Vassar, National Ombudsman and Assistant Administrator of Regulatory Enforcement Fairness, U.S. Small Business Administration
- Andrew Zuckerman, Director, TE/GE Employee Plans Rulings & Agreement

Other contacts:

- Paula Calimafde, Chair, Small Business Council of America
- Edward Ferrigno, Vice-President, Washington Affairs, Profit Sharing/§401(k) Council of America
- Judy Miller, American Society of Pension Professionals & Actuaries
- Aliya Wong, Director of Pension Policy, U.S. Chamber of Commerce
- Robert Yoder, Yoder & Landford, P.C.
- David E. Rogers, McDermott, Will & Emery

Appendix B:

Current Outreach Resources and Activities

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Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Retirement Plans Online Navigator						
IRS Retirement Plans Navigator website		Web guide to help small business employers choose and maintain plans and correct plan errors with links to Plan Pubs and Web pages on www.irs.gov.	Small business owners	Website	Google Adwords; previous newsrelease; one page flyer distributed at events and conferences; links on Employee Plans landing page; widget other organization can place on their own sites to link their users to the Navigator site; email blast regarding widget and site to partner organizations	Google analytics; report of clicks to monitor traffic from Adwords
Web Pages on IRS.gov/ep (Under Retirement Plans Community Tab on IRS.gov)						
Learning about Retirement Plans						
	http://www.irs.gov/retirement/sponsor/index.html	Landing page with links to Web pages and/or other resources for plan sponsors and employers.	Plan sponsors/employers	Web	None	We track the # of visitors to this URL per month. Content of pages is manually monitored and updated by both CE&O and technical staff

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
		Information on choosing, operating, participating in, correcting, and terminating specific types of retirement plans (IRA-based, 403(b), 401(k), etc.)	Plan sponsors	Web	None	We track the # of visitors to this URL per month. Content of pages is manually monitored and updated by both CE&O and technical staff
		Commonly used retirement plan terms defined, including some links to more detailed information	Participants, plan sponsors	Web	None	Content monitored by CE&O staff
		General information about starting, operating and terminating a retirement plan.	Plan sponsors	Web	None	We track the # of visitors to this URL per month. Content monitored by CE&O staff
		Tips on establishing or maintaining a retirement plan with links to related IRS publications.	Plan sponsors	Web	None	Content monitored by CE&O staff
		How to contact EP customer account services, listings of EP forms and publications, upcoming educational events	Practitioners and plan sponsors	Web	None	Content monitored by CE&O staff
Filing Requirements						
		Forms, instructions, supplemental guides, FAQs on notices, and EFAST vendors	Practitioners and plan sponsors	Web	None	We track the # of visitors to this URL per month. Content monitored by CE&O staff

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Correcting Mistakes in Retirement Plans						
		Overview of frequent errors and available correction methods for 401(k)s, SEPs, SARSEPs and SIMPLE IRA plans.	Practitioners and plan sponsors	PDF	None	Content monitored by CE&O staff
		Checklist highlighting some basic operational questions, plus links to Fix-It Guides and additional IRS resources (IRS Publications, FAQs, other web pages, etc.)	Plan sponsors	Web and PDF	None	Content monitored by CE&O staff
Understanding the Examinations Process						
		Overview of the examination function and what happens during an EP examination	Practitioners/plan sponsors	Web	None	Content of pages is manually monitored and updated by both CE&O and technical staff
		Explanations of what EPCU does and background on the 401(k) questionnaire project	Practitioners/ plan sponsors	Web	None	Content monitored by CE&O staff
		Collection of tips on recurring mistakes for employers to avoid	Plan sponsors	Web and PDF	None	We track the # of visitors to this URL per month. Content monitored by CE&O staff

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Determination/Opinion/Advisory Letters						
Determination, Opinion and Advisory Letters for Retirement Plans		Overview of Determination letter resources, including link to pre-approved plans (see link in 2nd paragraph on this page) and information for adopting employers (link from the pre-approved plan Web page)	Practitioners/plan sponsors, small business owners/employers	Web	None	Content monitored by CE&O staff
Phone Forums and Webinars						
Phone Forums						
Phone Forums		Free forums for registered participants on a variety of retirement plan topics, including many relevant to small business owners, *i.e.*, correcting SEP plans Pitfalls and Basics of Roth Conversions/Retirement Planning. Registration for future forums and archive of past forums are available on the Web page.	Benefit Practitioners and Plan sponsors/employers	Phone	Advertised in both EP newsletters, at conferences, on www.irs.gov/ep and to prior forum registrants	AT&T, which facilitates these forums, provides a list of registrants and a number of how many people call in for each forum
Webinars						
Webinars - 2 planned for FY 2011, one of which may be called Small Business Initiatives to specifically target small business owners.		2 free webinars on different retirement plan topics in 2011, which can be attended live and also archived for viewing later.	Benefit Practitioners and Plan sponsors/employers	Web based	Will advertise in both EP newsletters, at conferences and on www.irs.gov/ep	Unclear as of this time on how we will monitor the number of people who attend the webinar live or who later access its archive.

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Newsletters						
Retirement News for Employers		Periodic newsletter with retirement plan information for employers and business owners and their tax advisors	Small Business owners, Plan sponsors/employers , benefits and tax practitioners, plan participants/employees	Web based and downloadable PDF. An email is sent to subscribers whenever a new edition is posted	One page promotional flyer handed at conferences and events, mention during speeches and presentations at events	We monitor the number of people who subscribe, which number was 85,092 as of August 2010
Employee Plans News		Periodic newsletter with retirement plan information for retirement plan practitioners	Benefit Practitioners and Plan sponsors/employers	Web based and downloadable PDF. An email is sent to subscribers whenever a new edition is posted	One page promotional flyer handed at conferences and events, mention during speeches and presentations at events	We monitor the number of people who subscribe, which number was 93,447 as of August 2010
Print Publications						
Publication 3066, *Have you had your Check-up this year? for Retirement Plans*		An educational brochure designed to inform and encourage employers to perform a periodic "check-up" of their retirement plans through the use of the appropriate checklist, and how to initiate corrective action if necessary.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web.	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 3125, *The IRS Does Not Approve IRA Investments*		Alerts taxpayers that the Internal Revenue Service does not approve investments for Individual Retirement Accounts, especially those solicited by questionable phone or print advertisements.	Individuals	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web.	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 3636, *Employee Plans Brochure*		An informational pamphlet by TE/GE to describe the functional business units within the organization, intending that it be distributed at public functions. Specifically, the brochure highlights the services of Customer Education and Outreach, Rulings and agreements, Examinations and Customer Account Services.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 3998, *Choosing A Retirement Solution for Your Small Business*		Designed for tax practitioners with clients that may be able to sponsor a retirement plan. It contains a chart that highlights the primary types of retirement plans and key features specific to each type of program. It is designed and produced in conjunction with the Department of Labor.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4118, *Lots of Benefits - Retirement Plan Life Cycle*		An introductory brochure developed by TE/GE, in cooperation with the Department of Labor. Information is presented explaining the four phases of the life cycle of a retirement plan.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4222, *401(k) Plans for Small Businesses*		Designed for small business owners and tax practitioners with clients that may be able to start or already have a 401(k) plan. It contains basic information dealing with the establishing and operating of 401(k) plans and even highlights the basic types of 401(k) plans. It is designed and produced in conjunction with the Department of Labor.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4224, *Retirement Plan Correction Programs*		A tri-fold pamphlet describing retirement plan correction programs offered by the IRS, U.S. Department of Labor and Pension Benefit Guaranty Corporation.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4284, *SIMPLE IRA Plan Checklist*		An outreach informational tool that is designed to provide thought and assistance in the operation of a SIMPLE IRA Retirement Plan. The product is geared to the small business owner.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4285, *SEP Checklist*		An outreach informational tool that is designed to provide thought and assistance in the operation of a SEP plan. The product is geared to the small business owner.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4286, *SARSEP Checklist*		Outreach informational tool that is designed to provide thought and assistance in the operation of the SARSEP. The product is geared to the small business owner.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4324, *Employee Plan Examination Process*		Educational product that shows the Employee Plans Examination Process in the form of a flowchart. It is used primarily by EP Agents to explain the process to Taxpayers and their representatives at the beginning of an EP audit.	Small business owner and their tax advisors	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4333, *SEP Retirement Plans for Small Businesses*		Education and outreach tool designed for small business owners and tax practitioners with clients that may be able to start or already have a Simplified Employee Pension plan (SEP). It provides guidance on the establishment and operation of such plans and was produced in conjunction with the U.S. Department of Labor.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4334, *SIMPLE IRA Plans for Small Businesses*		A customer education and outreach tool designed for small business owners and tax practitioners with clients that may be able to start or already have a SIMPLE IRA Plan. It provides guidance on the establishment and operation of such plan.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4336, *SARSEP for Small Businesses*		Informational tool that provides guidance on the operation of a Salary Reduction Simplified Employee Pension (SARSEP)	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4407, *SARSEP - Key Issues and Assistance*		An educational product that addresses key issues, solutions and resources for assistance with Salary Reduction Simplified Employee Pension (SARSEP) Plans. It is also an introduction to the more comprehensive Publication 4336, SARSEPs for Small Businesses.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4460, *The Retirement Plan Products Navigator*		This product highlights many of the publications and brochures created by the Employee Plans, Customer Education and Outreach Division of TE/GE and deals with IRA Based Retirement Plans. It is targeted to small business owners.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events, promoted by items given away such as a magnet and a plastic bag bearing the logo from this publication	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4482, *403(b) Tax-Sheltered Annuity for Participant*		Directed at participants in a 403(b) annuity who are interested in learning more about the basic provisions and requirements in the operation of their plan along with pitfalls common with many 403(b) annuities.	403(b) participants	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4483, *403(b) Tax-Sheltered Annuity Plan for Sponsor*		Directed at plan sponsors/employers who are interested in learning more about a 403(b) annuity plan, the operational mistakes common to many of these plans and how to avoid and correct them.	403(b) plan sponsors	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4484, *Choose a Retirement Plan for Employees of Tax Exempt and Government Entities*		Designed for plan sponsors/employers of tax-exempt organizations and government entities who are interested in establishing a retirement plan for their employees. It contains a chart that highlights the different types of plans available and key features specific to each plan.	Small exempt organizations and business owners	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4530, *Designated Roth Accounts Under a 401(k) or 403(b) Plan*		An introductory educational brochure dealing with Designated Roth Accounts, a feature in many 401(k) and 403(b) plans. The brochure was created by EP CE & O.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4531, *401(k) Plan Checklist*		An outreach informational tool that is designed to provide thought and assistance in the operation of a 401(k) Plan. The product is geared to the small business owner.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4546, *403(b) Plan Checklist*		An outreach informational tool that is designed to provide thought and assistance in the operation of a 403(b) plan.	Small exempt organizations and business owners	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4587, *Payroll Deduction IRAs for Small Businesses*		Designed for small business owners and tax practitioners with clients who may be able to establish this kind of program. The publication contains basic information dealing with the establishment and operation of a payroll deduction IRA. It was designed, written and produced with the U.S. Department of Labor.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
Publication 4674, *Automatic Enrollment 401(k) Plans for Small Businesses*		A joint project of Employee Plans (EP) and the U.S. Department of Labor's Employee Benefits Security Administration (EBSA). It presents a basic look at the automatic enrollment feature for 401(k) plans and is directed toward small business owners.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Publication 4806, *Profit Sharing Plans for Small Businesses*		Designed for small business owners and tax practitioners with clients that may be able to start or already have a profit-sharing plan. It contains basic information dealing with the establishing and operating of profit-sharing plans. It is designed and produced in conjunction with the Department of Labor.	Small business owner	Print product - can be bulk ordered from IRS or PDF can be downloaded from the Web	Offered at conferences and other events	CE&O Keeps track of how many are published and ordered through the National Distribution Center
EP Videos and Mini-Courses						
IRS Employee Plans Videos		Web page to host videos produced by Employee Plans to provide another media to disseminate information regarding choosing, maintaining and correction retirement plans. In process of moving some videos to IRS You Tube Channel and IRS Video Portal Page	Individuals (participants/taxpayers), Small Business Owners, Practitioners	Web based video, WMV and Flash	1) previous news release promoting all EP videos; 2) links to individual videos and to this EP Video landing page on www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
The Navigator - Navigating Employer Information on Retirement Plans		Promotes EP Publications presented in the Navigator publication (Pub. 4460).	Small Business Owners, Practitioners	Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Maintaining Your Plan		Promotes the importance of maintaining a retirement plan and the EP tools available to assist. Video will be moved to IRS Video Portal Page	Business Owners, Practitioners	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Self-Correcting Plan Mistakes		Promotes EP Self-Correcting advantages and process. Video will be moved to IRS Video Portal Page	Business Owners, Practitioners	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Fixing Plan Mistakes Found During an IRS Audit		Explains the IRS Audit CAP program.	Business Owners, Practitioners	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Increasing Your Retirement Savings		Explains the importance of saving and starting early. Video will be moved to IRS You Tube Play List.	Individuals	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Managing Your IRA		Explains the importance and tips on due diligence for investing IRA assets. Video will be moved to IRS You Tube Channel	Individuals	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Starting a SEP or SIMPLE IRA Plan		Explains the steps and value of setting up a SEP or SIMPLE plan. Video will be moved to IRS You Tube Channel.	Small Business Owners, Practitioners	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
401(k) Plan Message		Discusses key issues of 401(k) Plans. Video will be moved to IRS You Tube Channel	Small Business Owners, Practitioners	WMV/Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
EP Examinations: FY 2010 EP Enforcement/ATAT		Presentation on our initiatives to combat ATATs	Individuals, Business Owners, Practitioners	WMV	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
EP Examinations: Employee Plans Team Audit		Introduces the EPTA (Large Case) Web page resources.	Business Owners, Practitioners	WMV	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
EP Examination: Employee Plans Compliance Unit		Explains what the EPCU is and introduces the Web page resources. This video will be moved to the IRS Videos Portal page.	Individuals, Business Owners, Practitioners	WMV	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
EP Determination Message		Encourages plan sponsors and practitioners to file DL requests early in the cycle to avoid delays and backlogs.	Business Owners, Practitioners	WMV	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
403(b) Program Message		Explains the progression of 403(b) program guidance and the forthcoming 403(b) DL program.	Schools, Tax Exempts and Practitioners	WMV	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
403(b) Tax-sheltered Annuity Plans-Employer		A mini-course that explains how to operate a 403(b) plan.	Schools, Tax Exempts and Practitioners	Flash and PDF	links on 403(b) plan pages on www/.irs.gov/ep.	Occasional feedback from Exempt Orgs which hosts this mini-course on it's portion of the stayexempt.irs.gov site

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
403(b) Tax-sheltered Annuity Plans-Employee		A mini-course that explains the advantages of participating in a 403(b) plan and how this type of plan works.	Participants and sponsors of a 403(b) plan	Flash and PDF	links on 403(b) plan pages on www/.irs.gov/ep .	Occasional feedback from Exempt Orgs which hosts this mini-course on it's portion of the stayexempt.irs.gov Web site
Virtual Small Business Tax Workshop		Video in Lesson 5 on how to set up a retirement plan. This video is a part of the SBSE Small Business Tax Workshop initiative.	Small Business Owners, Practitioners	Flash	links on one or several www/.irs.gov/ep Web pages where video pertains to subject matter.	Google analytics report of clicks to monitor traffic
Promotional Giveaways						
Magnifier	Exhibiting events	Wallet-size magnifier with IRS logo and web address	Benefits practitioners	Offered at exhibiting table at events and conferences	None	By reordering on an as needed basis based on feedback from exhibitors as to their desirability
Canvas tote bag	Exhibiting events	Canvas tote bag with IRS logo and web address	Benefits practitioners	Offered at exhibiting table at events and conferences	None	By reordering on an as needed basis based on feedback from exhibitors as to their desirability
Magnet	Exhibiting events	Small ruler shaped magnet promoting the Navigator print publication (publication 4460)	Benefits practitioners	Offered at exhibiting table at events and conferences	None	By reordering on an as needed basis based on feedback from exhibitors as to their desirability

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Plastic carry bag	Exhibiting events	Small plastic bag with the logo and promoting the Navigator print publication (publication 4460)	Benefits practitioners	Offered at exhibiting table at events and conferences	None	By reordering on an as needed basis based on feedback from exhibitors as to their desirability
Sticky pad with www.irs.gov/ep logo	Exhibiting events	Small sticky note pad with the www.irs.gov/ep along the bottom	Benefits practitioners	Offered at exhibiting table at events and conferences	None	By reordering on an as needed basis based on feedback from exhibitors as to their desirability
National Conferences and Events						
FY 2010 (October 1, 2009 to September 30, 2010)						
Conference	San Jose	American Society for Public Administration (Annual Conference)	Public Administrators	Exhibiting	Exhibiting	Feedback
Annual Meeting	Washington, DC	Society of Actuaries (Annual Meeting)	Actuaries	Exhibiting	Exhibiting	Feedback
Conference	Seattle	American Association of Community Colleges	College Administrators	Exhibiting	Exhibiting	Feedback
Conference	Minneapolis	National Center for Employee Ownership (ESOP's)	ESOP Administrators	Speaker & Exhibiting	Exhibiting	Feedback
Annual Meeting	Uncasville, CT	American Association of Attorney-Certified Public Accountants	Attorneys/CPA's	Exhibiting	Exhibiting	Feedback
Annual Meeting	Las Vegas	National Institute of Pension Administrators (Annual Forum & Expo)	Pension Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	Las Vegas	National Conference of Public Employee Retirement Systems - Annual	Public Administrators	Exhibiting	Exhibiting	Feedback

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Eastern Regional	Washington, DC	College & University Professional Assoc. for Human Resources	HR Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	Washington, DC	American Bar Association (20th Annual Section on Taxation)	Attorneys	Exhibiting	Exhibiting	Feedback
Conference	Chicago	National Tax Sheltered Accounts Association (403(b) Problem Resolution)	Pension Professionals	Floater	Information Exchange	Feedback
Annual Meeting	Las Vegas	American Institute of Certified Public Accountants (Employee Benefits)	CPA's	Speaker & Exhibiting	Exhibiting	Feedback
Conference	Washington, DC	United States Chamber of Commerce (Small Business Summit)	Small Business	Exhibiting	Exhibiting	Feedback
Conference	Chicago	National Association of Personal Financial Advisors (Conference)	Financial Advisors	Exhibiting	Exhibiting	Feedback
Conference	National Harbor, MD	American Payroll Association - 28th Annual Congress	Payroll Professionals	Exhibiting	Exhibiting	Feedback
Conference	San Antonio	American Society of Pension Professionals & Actuaries	Pension Professionals	Exhibiting	Exhibiting	Feedback
Conference	Washington, DC	SPARK was National Defined Contribution Council - National Conference	Pension Professionals	Exhibiting	Exhibiting	Feedback
Conference	Chicago	PlanSponsor (PlanSponsor National Conference)	Pension Professionals	Exhibiting	Exhibiting	Feedback
Conference	Chicago	American Society of Pension Professionals & Actuaries	ERPA Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	Albuquerque	American Association of Attorney-Certified Public Accountants (47th Annual)	Attorneys/CPA's	Exhibiting	Exhibiting	Feedback

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Conference	Washington, DC	National Association of College & University Attorneys	Attorneys	Exhibiting	Exhibiting	Feedback
Conference	Atlanta	Government Finance Officers Association (104th Annual Conference)	Finance Officers	Exhibiting	Exhibiting	Feedback
Annual Meeting	New Orleans	National Education Association (148th Annual Meeting & 89th Rep. Assembly)	Education Professionals	Exhibiting	Exhibiting	Feedback
Conference	Coral Gables, FL	American Institute of Certified Public Accountants - Small Business Practitioner	CPA's	Exhibiting	Exhibiting	Feedback
Conference	Austin	National Association of Tax Professionals	Tax Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	San Francisco	National Association of College and University Business Officers - Annual Meeting	College Administrators	Exhibiting	Exhibiting	Feedback
Annual Meeting	Charleston	Association of Public Treasurers of the United States and Canada (45th Annual)	PublicTreasurers	Exhibiting	Exhibiting	Feedback
Conference	Kansas City, MO	National Conference of State Social Security Administrators (Annual Conference)	Soc. Sec. Admin.	Speaker & Exhibiting	Exhibiting	Feedback
Conference	San Diego	Employers Council on Flexible Compensation (23rd Annual Flexible Admin. Symposium)	Benefits Practitioners	Exhibiting	Exhibiting	Feedback
Annual Meeting	Arlington	National Society of Accountants (65th Annual Meeting)	Accountants	Exhibiting	Exhibiting	Feedback
Conference	Philadelphia	National Association of Government Defined Contribution Administrators	Benefits Practitioners	Exhibiting	Exhibiting	Feedback

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Annual Meeting	Silicon Valley, CA	Women In Technology International - 21st Annual Summit	Small Business	Exhibiting	Exhibiting	Feedback
Conference	Arlington	American Society of Pension Professionals & Actuaries - DOL Speaks	Actuaries	Exhibiting	Exhibiting	Feedback
Conference	Las Vegas	American Payroll Association - Fall Forum	Payroll Professionals	Exhibiting	Exhibiting	Feedback
Conference	Amelia Island, FL	Profit Sharing 401(k) Council of America - 63rd Annual Conference	Pension Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	Orlando	Association of School Board Officials - 96th Annual Convention	Education Professionals	Exhibiting	Exhibiting	Feedback
Conference	Las Vegas	University Conference Services	College Administrators	Exhibiting	Exhibiting	Feedback
Conference	Orlando	American Association of Retired Persons (50+)	Participants/Retired	Exhibiting	Exhibiting	Feedback
Nationwide Tax Forums (6)	Atlanta, Chicago, Orlando, New York, Las Vegas and San Diego	Nationwide Tax Forum	Tax Professionals	Speaker & Exhibiting	Exhibiting	Feedback
Currently Scheduled for FY 2011 (October 1, 2010 to September 30, 2011) - additional events to be added as scheduled						
Annual Meeting	Boston	Retirement Income Industry Association (Annual Meeting & Awards Dinner)	Pension Professionals	Exhibiting	Exhibiting	Feedback
Conference	Chicago	University Conference Services	College Administrators	Exhibiting	Exhibiting	Feedback
Annual Meeting	Palm Springs, CA	National Conference of Public Employee Retirement Systems (Annual)	Public Administrators	Exhibiting	Exhibiting	Feedback
Conference	Myrtle Beach	American Association of School Personnel Administrators (72nd Annual Conf)	Public Administrators	Exhibiting	Exhibiting	Feedback

Resource Name	Location	Description	Primary Target Audience	Format/Method of Delivery or Distribution	Marketing Campaign	Monitoring Mechanism
Conference	Baltimore	American Council of Life Insurers - 2010 Annual Conference	Insurance Benefits	Exhibiting	Exhibiting	Feedback
Annual Meeting	National Harbor, MD	American Society of Pension Professionals & Actuaries - Annual	Pension Professionals	Exhibiting	Exhibiting	Feedback
Conference	New Orleans	American Payroll Association (EIPC) - Educational Institution Payroll Conference	Payroll Professionals	Speaker & Exhibiting	Exhibiting	Feedback
Annual Meeting	New York City	Society of Actuaries (Annual Meeting & Exhibit)	Actuaries	Speaker & Exhibiting	Exhibiting	Feedback
Conference	Chicago	Tax Executives Institute - 65th Annual Conference	Tax Professionals	Exhibiting	Exhibiting	Feedback
Annual Meeting	Rancho Mirage, CA	Conference of Consulting Actuaries - Annual Meeting	Actuaries	Exhibiting	Exhibiting	Feedback
Conference	Washington, DC	American Institute of Certified Public Accountants - National Tax Conference	CPA's	Exhibiting	Exhibiting	Feedback
Conference	Las Vegas	The ESOP Association (Conference & Trade Show)	ESOP Administrators	Speaker & Exhibiting	Exhibiting	Feedback
Conference	Hilton Head, SC	Community College Business Officers (Linked with NACAS)	College Administrators	Exhibiting	Exhibiting	Feedback
Conference	Denver	Association for Financial Counseling and Planning Education	Financial Advisors	Exhibiting	Exhibiting	Feedback
Conference	Washington, DC	American Institute of Certified Public Accountants (Employee Benefits)	CPA's	Exhibiting	Exhibiting	Feedback
Conference	Los Angeles	Latin Business Association (Business Conference & Expo)	Small Business	Exhibiting	Exhibiting	Feedback
Nationwide Tax Forums (6)	Atlanta, Orlando, Dallas, Anaheim, Las Vegas and National Harbor, MD.	Nationwide Tax Forum	Tax Professionals	Presenting & Exhibiting	Exhibiting	Feedback

Appendix C:
The Service Provider Survey

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IRS ACT EMPLOYEE PLANS SUBCOMMITTEE
Service Provider Survey – Fall 2010

1. Who Are You?	
Consultant 3rd party	56.0%
Attorney	19.1%
Bundled Services	15.6%
Actuary	7.8%
Unbundled Recordkeeper	7.8%
Accountant	3.5%
Payroll Provider	1.4%
Other	9.2%
2. Type of Retirement Plans	
§401(k)	95.0%
Money Purchase Pension	62.4%
Defined Benefit Plan	62.4%
§403(b)	48.9%
SIMPLE IRA/ §401(k)	26.2%
SEP	22.7%
Other	32.6%
3. Small Plans You Advise	
1-10	9.3%
11-50	20.0%
51-500	38.6%
501 or more	32.1%
4. Do You Regularly Use:	
Employee Plans Web Pages	95.7%
IRS Retirement Plans Navigator	36.6%
DOL and AICPA	11.8%
5. Refer Clients to:	
Employee Plans Web pages	89.6%
IRS Retirement Plans Navigator	37.5%
Choosing a Retirement Solution	20.8%
6. Type of Information Sought	
Correcting Plan Errors	73.9%
Determination, Opinion and Advisory Letters	54.3%
Examinations	35.9%
Types of Plans	19.8%
Other	34.8%
7. Other Web Based Use	
Benefitslink.com	94.8%
ASPPA	72.4%
Plansponsor.com	62.9%
American Benefits Council	23.3%
Investment Co Institute	14.7%

AICPA	13.8%
Society HR Mgmnt	7.8%
NFIB Legal Ctr	1%
Other	31.9%
8. Communicate with the Following Tools:	
LinkedIn	72.1%
Facebook	14.0%
Message Board	14.0%
Twitter	9.3%
Blog	7.0%
MySpace	0%
Other	30.2%
9. Identify Two Organizations Used for Continuing Education	
ASPPA	60
NIPA	14
SunGard	12
ALI-ABA	11
American Bar Association	8
Relius	5
American Academy of Actuaries	4
McKay Hochman	4
AICPA	3
Corbel	3
IRS	3
PenServ	3
F360	2
College for Financial Planning	2
Conference of Consulting Actuaries	2
International Foundation	2
PLI	2
Southern Employee Benefits Conference	2
AAA-CPAs	1
ABA Employee Benefits Committee	1
ACOPA	1
AIRE	1
Ascensus	1
AXA Equitable Sales Consultants	1
Center for Fiduciary Studies	1
Colorado Bar Association	1
EBIA	1
ESOP Association	1
Fox River Area Pension Professional Society	1
Indiana State Bar Association	1
Local Bar Association	1
McGladrey & Pullen	1
Michigan Bar Association	1

National Benefits Administrators	1
NJSCPA	1
PPA	1
Western Pension Conference	1
10. Type of documentation	
Summary Plan Description	86.0%
Summary of Material Modifications	81.3%
Volume Submitter	74.8%
Master/Prototype	64.5%
Individually Designed	46.7%
11. "Blank" or "Sample" Form Use	
We complete it	91.7%
We do not complete it	5.5%
Other	10.1%
12. Confirm--Completed all legally-required paperwork	
Yes	83.3%
No	9.3%
Other	12.0%
13. Provide Updates to Plan Documentation	
Yes	95.5%
No	4.5%
Other	1.8%
14. "Adopt" Updates Automatically	
Yes	56.3%
No	43.7%
15. Perform Testing (Maximum Deferral, Maximum Contribution, Etc.)	
Yes	74.8%
No	25.2%
16. Perform Nondiscrimination Testing	
Top-Heavy Determination	96.3%
ADP/ACP Testing	93.8%
Coverage Testing	92.6%
General Nondiscrimination Testing	91.4%
Compensation Ratio Testing	75.3%
17. Highly Compensated Emp. and Key Emp.	
Your Organization	73.8%
The Client	23.3%
Other	14.6%
18. Testing Failure--Who Manages Correction	
Your Organization	71.0%
The Client	20.0%
Other	22.0%
19. Types of Notices & Government Filings	
Safe Harbor Auto Enrollment	81.2%
Form 5500 Signature Ready	79.2%
Summary Annual Reports	78.2%

Qualified Default Investment Alternatives	60.4%
Form 5330	59.4%
Determination Letter Packages Signature Ready	59.4%
PBGC Filings	42.6%
Form 5500 Sample	8.9%
Determination Letter Packages Sample	8.9%
20. Include Information In Form 5500	
We review plan census and financial information	81.0%
We require our clients to provide us with responses	24.1%
Other	16.5%
21. Assist Clients w/ Corrections Using EPCRS	
Yes	75.7%
No, I refer clients to an atty. for this type of work	24.3%
I don't know what EPCRS is	0.0%
22. Having to Submit Certain Voluntary Corrections to the IRS	
Discourages correction	44.7%
Encourages correction	28.2%
No impact	27.2%
23. IRS Approval—Without A Formal IRS Submission	
More likely to use	83.8%
Less likely to use	1.9%
No impact on use	14.3%
24. Inform IRS of Correction but Not Request Approval	
More likely to use	56.6%
Less likely to use	16.2%
No impact on use	27.3%

Appendix D:
Small Business Clinics

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Current List of Law School Small Business Clinics:

- Columbia Law School Nonprofit Organization/Small Business Clinic
- George Washington University Community Legal Clinics, Small Business Clinic
- Lewis & Clark Law School's Small Business Legal Clinic (SBLC)
- Northwestern University School of Law Small Business Opportunity Clinic
- SMU Dedman School of Law Tax Clinic – Small Business Project
- University of the District of Columbia Small Business Clinic
- University of Pennsylvania Small Business Clinic
- USC Law Small Business Clinic (SBC)
- Wayne State University Law School Small Business Enterprises & Nonprofit Corporation Clinic
- Yale Law School Ludwig Community Development Program and Clinic

Other Not-for-Profit Clinics:

- Center for Economic Progress
- Prairie State Legal Services (PSLS)

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