



Tax Exempt & Government Entities

TE/GE

Advisory Committee on  
Tax Exempt and Government Entities (ACT)

# Report of Recommendations

Public Meeting  
Washington, DC  
June 6, 2012

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**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

Public Meeting  
1111 Constitution Ave., NW  
Washington, DC 20224

June 6, 2012

## 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
- David N. Levine, Chair of the ACT

### Reports of Recommendations

- **Employee Plans:** Analysis and Recommendations Regarding the Scope of the Employee Plans Examination Process
- **Exempt Organizations:** Form 1023 - Updating It for the Future
- **Federal, State and Local Governments:** TIN Matching as an Effective Online Business Tool to Improve Compliance
- **Indian Tribal Governments:** Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members
- **Tax Exempt Bonds:** A Survey of IRS Forms for Information Reporting

### Closeout

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**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**2011-2012  
Member Biographies**

**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.

**Stephen L. Ferszt, New York, NY**

Mr. Ferszt is chair of the Employee Benefits and Executive Compensation Group at Tarter Krinsky & Drogin LLP. He counsels clients ranging from Fortune 100 companies to small employers on all aspects of qualified retirement plans (defined contribution and defined benefit). He also counsels tax-exempt organizations on issues involving public charities and private foundations. Mr. Ferszt served as Chair of the Tax Section of the New Jersey State Bar Association and its Employee Benefits Committee. He is also a member of the IRS Northeast Pension Liaison Group, and a fellow of the American College of Trust and Estate Counsel where he serves on its Employee Benefits in Estate Planning committee. Mr. Ferszt received his Juris Doctorate from the Benjamin N. Cardozo School of Law of Yeshiva University and is a member of the New York and the New Jersey State Bars.

**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. Mr. Levine 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.

**Joan E. McCabe**, Scarborough, ME

Ms. McCabe is the managing partner of Actuarial Designs & Solutions, Inc, an independent actuarial consulting and retirement plan administration firm. She is a consulting actuary and provides plan design and consulting services for numerous defined benefit, 401(k) profit-sharing, ESOP, and nonqualified executive retirement plans. Ms. McCabe is an Enrolled Actuary, an Associate in the Society of Actuaries, a Member of the American Academy of Actuaries, and a Member of the American Society of Pension Professionals & Actuaries. She holds a Masters degree in Actuarial Science from the University of Nebraska and a Bachelor of Science degree in Mathematics from the State University of New York.

**Adam C. Pozek, Salem, NH**

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 is enrolled to practice before the IRS as an Enrolled Retirement Plan Agent, and he holds the professional credentials of Qualified Plan Administration (QPA), Qualified Plan Financial Consultant (QPFC), and Registered Employee Benefits Consultant (REBC).

**EXEMPT ORGANIZATIONS**

**Eric B. Carriker, Boston, MA**

Mr. Carriker is an assistant attorney general and the senior litigation manager in the Non-Profit Organizations/Public Charity Division of the Massachusetts office of the Attorney General. He conducts and supervises investigations and litigation that covers a broad spectrum of issues connected with the Attorney General's oversight of charities that includes: (i) enforcing state registration and reporting requirements; and (ii) ensuring that charitable assets are properly managed, charitable fiduciaries fulfill their duties of loyalty and care, donor intent is fulfilled, and that fraudulent fundraising is remedied. Mr. Carriker previously served as a board member and as president of the National Association of State Charities Officials. He is a graduate of Harvard College and Boston University Law School.

**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.

**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.

**Marty Martin**, Raleigh, NC

Mr. Martin established Marty Martin Law Firm to provide legal services to nonprofit and tax exempt organizations and training for their boards and senior management. Mr. Martin is an instructor for the Duke University Nonprofit Management Certificate and, related, Intensive and Advanced Certificate in Nonprofit Leadership programs. He authors *The Nonprofit Mentor* blog, and frequently speaks on issues related to nonprofit organizations. Mr. Martin received a Masters in Public Administration degree with a concentration in managing nonprofit and public sector organizations from the Harvard Kennedy School, and a Juris Doctorate degree from the Western New England University School of Law.

**Celia 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.



## **GOVERNMENT ENTITIES: FEDERAL, STATE AND LOCAL GOVERNMENTS**

### **Robert E. Jaros, Boulder, CO**

Mr. Jaros is Deputy Controller for the State of Colorado. He is responsible for addressing technical tax law issues, implementing new legislative provisions, reporting and analysis, payroll, accounting and recovery audits, and has worked with FSLG to address various technical tax issues. He serves as part-time accounting instructor at the Metropolitan State College in Denver, CO. Mr. Jaros received the Community Engagement Award from the Center for Urban Connections; and is a member of the AICPA, and the National Association of State Auditors, Controllers and Treasurers. Mr. Jaros received his Juris Doctorate from the University of Detroit School of Law; his Masters in Business Administration from Columbia University Graduate School of Business; and his Bachelor of Arts from Rutgers University.

### **Lisa M. Pusich, Juneau, AK**

Ms. Pusich is the State Accountant for the State of Alaska. She is the state liaison with the IRS for all tax matters including return filing and overall tax compliance. She oversees the accounting services and payroll section for the state and is directly involved in implementing new tax provisions. She is responsible for addressing a myriad of technical tax law issues that affect withholding and information reporting. Ms. Pusich has a Bachelor of Arts Degree in Accounting from Western Washington University in Bellingham, WA, and a CPA license in the State of Alaska. She is a member of the AICPA; Association of Government Accountants; and the National Association of State Auditors, Controllers and Treasurers.

### **Kathy Sheppard, Boston, MA**

Ms. Sheppard is Deputy Comptroller for the Commonwealth of Massachusetts, Office of the Comptroller. She is responsible for the tax reporting and compliance issues for all government entities in the commonwealth and works directly with the IRS to address and resolve various tax matters. Ms. Sheppard is responsible for implementation and direction of the state accounting and payroll system for all departments within the state. She serves on the Lieutenant Governor's Task Force on the Prevention of Fraud, Waste and Abuse. Ms. Sheppard is a member of the National Association of State Auditors, Controllers and Treasurers.

## **GOVERNMENT ENTITIES: INDIAN TRIBAL GOVERNMENTS**

### **Holly Easterling, Ada, OK**

Ms. Easterling is Administrator of Planning and Organizational Development for the Chickasaw Nation in Ada, OK, where she work directly with Governor Bill Anoatubby to ensure that the financial and strategic needs of the tribal government are realized. She served as an elected official in the tribe's legislature including serving as Chair of the legislature and Chair of the Finance Committee. She also served as Controller for Chickasaw Enterprises, the business division of the Chickasaw Nation, which owns and operates one of the largest casinos world-wide. Ms. Easterling graduated from Oklahoma State University with a bachelor's degree in accounting, and became a CPA in 1990.

### **William “Yaan Yaan Eesh” Micklin, Alpine, CA**

Mr. Micklin is Vice President of the Central Council of Tlingit & Haida Indian Tribes of Alaska, and represents over 28,000 tribal citizens. He is CEO for the Ewiiapaayp Band of Kumeyaay Indians; Executive Director of the California Association of Tribal Governments; and a member of the Alaska Native Brotherhood Camp 14 in Ketchikan. Mr. Micklin serves on the Department of Energy Indian Country Energy & Infrastructure Workgroup; and is Co-Chair of the Tribal Self-Governance Title IV Amendment Workgroup. He has served as a member of the FCC Intergovernmental Advisory Committee; and the Department of Interior Tribal Energy Policy Advisory Committee. Mr. Micklin has a B.A. in English Literature from the University of Washington.

### **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 regularly 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

### **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* (5<sup>th</sup> Edition). Mr. Magnatta received his Juris Doctorate from Temple University, and an LLM in Taxation from the Georgetown University Law Center.

### **J. Sue Painter**, Seattle, WA

Ms. Painter is System Director, CIO/Treasurer of her firm, Providence Health & Services, which is a multistate not-for-profit health care system with revenues in excess of \$6.7 billion. She is responsible for the issuance of over \$3 billion in debt financing. She served as Treasurer of Public Utility District of Clark County. She was responsible for the debt issuance of a local government issuer. Ms. Painter previously served as an investment executive with a major investment bank. Ms. Painter has an MBA from the University of Portland, and a BS in Business Admin/Finance from Portland State University, OR.

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

This General Report is presented in connection with the 11th annual public meeting of the IRS Advisory Committee on Tax Exempt and Government Entities (ACT). The members of the ACT appreciate the ongoing opportunity to engage with and report to the Internal Revenue Service on items of importance to the Tax Exempt and Government Entities (TE/GE) division and its stakeholders. The individual reports from ACT subcommittees representing Employee Plans, Exempt Organizations, Federal State and Local Governments, Indian Tribal Governments, and Tax Exempt Bonds reflect the diligent efforts of the subcommittees, the TE/GE directors and staff, and stakeholders in the community over the past 12 months.

This year there are five reports:

- **Employee Plans:** Analysis and Recommendations Regarding the Scope of the EP Examination Process
- **Exempt Organizations:** Form 1023 – Updating It for the Future
- **Federal, State and Local Governments:** TIN Matching as an Effective Online Business Tool to Improve Compliance
- **Indian Tribal Governments:** Report on the General Welfare Doctrine as Applied to Indian Tribal Governments and Their Members
- **Tax Exempt Bonds:** A Survey of IRS Forms for Information Reporting

The collaborative efforts of the ACT members, the Service, and the various stakeholder groups combined make these insights possible.

Each year, approximately one-third of our 21 members complete their term. We thank them for their wisdom and sharing of their unique insights during their service. They are:

- David Cholst
- Barbara A. Clark
- J. Daniel Gary
- James P. Joseph
- Kathryn J. Kennedy
- George T. Magnatta
- Wendy S. Pearson

In 2011-2012, we note that the Service encouraged and actively facilitated the first virtual meeting among members of the ACT and the Service. We recognize that the Service has limited resources available, and we appreciate its ongoing commitment to the ACT's activities in these times of fiscal austerity.

The ACT wishes to acknowledge and express its gratitude for the Service's willingness to look to the ACT for its insights. Specifically, we would like to thank Commissioner Douglas H. Shulman for his support. We also wish specifically to thank TE/GE Commissioner Sarah Hall Ingram, Acting TE/GE Commissioner Joseph Grant, Acting TE/GE Deputy Commissioner Moises Medina, and TE/GE Directors and Acting Directors Robert Choi, Lois Lerner and Clifford Gannett. Of special note, we wish to thank Bobby Zarin and Cynthia PhillipsGrady for their skilled oversight and management of the ACT process.

Lastly, we wish to specially thank the dedicated employees of TE/GE. They provide invaluable information, insights, and guidance for our reports each year and devote their careers to working in a collaborative manner with TE/GE stakeholders. They help make possible the unique collaboration of the stakeholder community with the Service that facilitates compliance with and practical implementation of the tax laws governing the TE/GE community.

**David N. Levine**

ACT Chair

2011-2012

**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Employee Plans:  
Analysis and Recommendations  
Regarding the Scope of the EP Examination Process**

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Stephen L. Ferszt, Esq.  
Kathryn J. Kennedy, Esq., FSA  
David N. Levine, Esq.  
Joan E. McCabe, ASA, EA  
Adam C. Pozek, ERPA

**June 6, 2012**

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## **I. Executive Summary**

This year, the Employee Plan's (EP) portion of the ACT Report focuses on EP's determination as to the scope of its auditing process when examining retirement plans, primarily those that are "qualified" under section 401(a) of the Internal Revenue Code of 1986, as amended ("IRC" or "Code").<sup>1</sup> Such plans are considered to be tax-exempt entities. EP Examinations (EP Exam) is charged with overseeing retirement plans' compliance with the Code's applicable provisions and the terms of the plan so that plan assets and the rights of participants are protected.<sup>2</sup> To carry out its mission, EP Exam conducts audits of retirement plans that are selected on the basis of criteria developed over the years. The selection of appropriate plans for examination (i.e., those most likely to be noncompliant) is essential to EP Exam's efficient operation and wise use of limited resources. Over time, EP Exam has refined its sampling techniques and methodology and has identified a number of indicators that help it predict which plans and specific plan functions are most likely to be noncompliant.<sup>3</sup>

More recently as part of a pilot project involving large plans, a group of EP examiners began testing the adequacy of the internal controls<sup>4</sup> over essential plan administrative systems across all plans within the controlled group before finalizing the scope of an audit. The underlying theory was simple. If a plan sponsor can show through its responses to an Internal Revenue Service (IRS or Service) questionnaire that it has checks and balances integrated into the administration of the essential plan operations that the IRS has identified as prone to error,<sup>5</sup> further probing by the examiner is unlikely to uncover instances of noncompliance. The examiners can then move on to other plan operations or other plans, thereby leveraging EP Exam's audit resources and lightening the plan sponsor's burden—two productive outcomes. On the other hand, if a plan sponsor's responses to inquiries on the plan's systems and procedures point to weak or even nonexistent internal controls, the examiners should look further.

We believe there is another benefit that a focus on plans' internal controls, particularly systems-based controls, can confer, which is the promotion of a consistent message across all EP functions. The message is that strong internal controls over administrative operations are basic to good plan administrative governance, which in turn is critical to maintaining a compliant retirement plan. That message is already built into many existing EP materials,

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<sup>1</sup> All sections referenced herein are to the IRC unless otherwise indicated. EP also has jurisdiction over tax-advantaged plans not qualified under section 401(a), such as 403(b) and 457(b) plans.

<sup>2</sup> See <http://www.irs.gov/retirement/article/0,,id=147731,00.html>.

<sup>3</sup> See, e.g., <http://www.irs.gov/retirement/article/0,,id=206511,00.html>.

<sup>4</sup> The plan sponsor is ultimately responsible for ensuring the adequacy of a plan's internal controls regardless of whether plan administrative functions are handled internally or externally. For those plan operations that are outsourced, the plan sponsor must establish a process for monitoring the external service provider's performance.

<sup>5</sup> See *id.*

such as the self-audits, Fix-It Guides,<sup>6</sup> checklists<sup>7</sup> and questionnaires.<sup>8</sup> These materials describe best practices that evidence good internal controls without necessarily using that terminology. Making the message more explicit and inserting it in materials used across all functions will increase the impact.

For our purposes, “internal controls” refers to the processes and procedures that are adopted and applied to ensure that plan administration is consistent with the terms of the plan document. Systems controls over the business environment of the plan (e.g., payroll, census data, human resources (HR)) are an essential element of internal controls, but that phrase also includes the personnel who are responsible for various duties under the plan. The processes and procedures may include activities and documentation prepared and maintained by the plan sponsor or a service provider, such as a record keeper or third party administrator.

Section II (**Background**) describes the evolution of plan audits under the stewardship of EP Exam, from early issue spotting, based on Form 5500 responses to an increasingly data-driven approach that can target existing and emerging high risk areas, and more recently to the focus on the plan’s internal controls.<sup>9</sup>

Section III (**Assessment of Existing Materials on Internal Controls from the Perspective of Plan Sponsors and Outside Service Providers**) provides an assessment of the existing IRS materials available to plan sponsors and outside service providers on the IRS website and offers recommendations on how they could be made more robust by incorporating concrete suggestions based on internal control concepts. It provides substantive recommendations on how a focus on internal controls can be integrated into the entire EP process so the message is reinforced at each stage—Customer Education and Outreach (CE&O) and EP Exam materials (questionnaires, initial contact letter, and information document requests).

Appendix A suggests some processes for establishing and maintaining essential plan administrative functions that: incorporate adequate internal controls to support ongoing compliance, increase the likelihood of a quick audit, and reduce the costs of bringing a plan back into compliance through an IRS program if an error occurs.

Appendix B provides a more detailed description of EP and its role within the Tax Exempt and Government Entities (TE/GE) division.

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<sup>6</sup> See <http://www.irs.gov/retirement/sponsor/article/0,,id=181908,00.html>.

<sup>7</sup> See <http://www.irs.gov/pub/irs-tege/pub4531.pdf>.

<sup>8</sup> See [http://www.irs.gov/pub/irs-tege/401k\\_interim\\_report.pdf](http://www.irs.gov/pub/irs-tege/401k_interim_report.pdf).

<sup>9</sup> See *IRS Strategic Plan*, <http://www.irs.gov/pub/irs-pdf/p3744.pdf>.

Appendices C through F provide samples of EP Exam materials that could incorporate a focus on internal controls.

Appendix G lists the government personnel and private individuals who provided input and/or were consulted for purposes of this EP Report.

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## **II. Background**

### **A. Goal of EP Exam**

The goal of EP Exam is to protect plan assets to assure plan participants that benefits will be paid as promised and in accordance with federal law.<sup>10</sup> The charge of EP Exam is to promote compliance, as opposed to generate revenue. One part of an effective compliance program is the function of examination. The goals of examination are to determine that: contributions are made when required, assets exist to satisfy plan liabilities and are properly classified as assets, and plan operations are in accordance with plan design. In the past, methods used to ensure compliance include: EP CE&O web-based tools and products; Employee Plans News, Retirement News for Employers, and Government Plan Updates; and IRS phone forums. There is an Examination Process Guide that provides plan sponsors and practitioners with a roadmap as to what occurs during an exam including a section on correcting issues, communications, and the appeals process.<sup>11</sup>

Once noncompliance is found on examination, the goal is to bring the plan back into compliance. Mistakes identified under exam may be corrected through the Audit Closing Agreement Program (Audit CAP) of the EP Compliance Resolution System (EPCRS).<sup>12</sup> The IRS has a variety of tools to assure such compliance including penalties, excise taxes and interest charges, and plan disqualification. EP Exam has approximately 550 employees, 350 of whom are revenue agents specializing in EP enforcement work to ensure retirement plan compliance.

### **B. EP Exam Priorities**

On the IRS website, Monika Templeman, Director, EP Exam, lists the exam priorities for the current fiscal year, which are intended to produce a prominent exam presence in the retirement plans community.<sup>13</sup> EP Exam priorities include:

- **International Issues:** Department of the Treasury and Puerto Rico Hacienda are now sharing resources and tax information in order to provide a “unified compliance front” to the extent U.S. employers have employees working outside the United States, which could impact U.S. retirement plans. The EP Compliance Unit (EPCU) completed two international compliance check projects on foreign distributions and domestic trusts.

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<sup>10</sup> See IRS Article, *supra* note 2 for a description of the responsibilities of EP Exam.

<sup>11</sup> See EP Exam Process, [http://www.irs.gov/pub/irs-tege/exam\\_overview.pdf](http://www.irs.gov/pub/irs-tege/exam_overview.pdf).

<sup>12</sup> Rev. Proc. 2008-50, 2008-35 I.R.B. 464, §13.

<sup>13</sup> See *EP Examination Process Guide*, <http://www.irs.gov/retirement/article/0,,id=135076,00.html>.

- **401(k) Compliance Project:** EP is reevaluating ways (e.g., education, guidance, outreach) to better serve the 401(k) community and prevent noncompliance.
- **Governmental Plans Community:** EP is striving to promote attentiveness to compliance issues and to better dialogue with this group of retirement plan sponsors.
- **Abusive Transactions:** EP continues to identify abusive transactions and to track emerging issues that may not give rise to per se abuse, with the assistance of the practitioner community.<sup>14</sup>

### **C. Full Examination**

An examination of a retirement plan begins when a revenue agent notifies the plan sponsor about the exam either by phone or through a letter.<sup>15</sup> A confirmation letter follows this initial contact and details the list of items to be provided during the examination. An attorney, accountant, enrolled agent, enrolled actuary, or the person who prepared and signed the return as preparer may accompany the plan sponsor in an audit. An appointment date will be set between the employer or an authorized representative and the IRS agent. The IRS agent will then conduct an on-site audit of the plan, which is normally held at the employer's place of business.

The IRS uses Form 4564, Information Document Request (IDR), to notify the plan sponsor of the plan that is being examined, the tax years to be examined, and the information being requested in conjunction with such exam. For example, the IRS may wish to examine the following participant account information for each participant for a given tax year: name; employee ID; employee's Social Security Number; company name, unit, or division; original date of hire; subsequent dates of hire; date of birth; date of termination; reason for termination; employment classification; date of plan entry; whether the employee is a highly compensated employee; plan number; marital status; account information at the beginning and at the end of the year; and citizenship status. The requesting agent's name, ID number, office, and contact information are noted.

The IRS strives for uniformity in IDRs nationally, with flexibility to customize as requested by the examiner. Small plans typically get a lengthy initial inquiry (e.g., list of items required during the examination), whereas larger plans may receive multiple IDRs that are distributed as the audit progresses. International plans have a different set of IDRs.

A full scope audit involves a complete examination of the plan's books and records to assure that the plan's form and its operation are compliant. The definition of when a plan is "under

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<sup>14</sup> See *id.*

<sup>15</sup> See Publication 4324 (Rev. 11-2011). See also *supra* note 13.



examination” is complex.<sup>16</sup> It begins when the employer has been given notice of the audit (either orally or in writing). Once it begins, the plan sponsor cannot file for relief under the Voluntary Compliance Program (VCP) and, except for significant failures for which self-correction is more than 65% complete,<sup>17</sup> self-correction of significant failures under the Self-Correction Program (SCP) becomes unavailable. However, insignificant failures can be self-corrected during an audit.<sup>18</sup>

During the initial interview with the revenue agent, the plan sponsor or its representative will explain the plan’s administrative practices and procedures so that the agent can better understand the plan and its operations, resulting in a more efficient exam. Common areas of plan review include: eligibility, vesting, discrimination, top heavy requirements, contribution and benefit maximum limitations, funding and deductions, distributions, trust activities, plan and trust documents along with amendments, and returns and reports relating to the plan. Based on the information provided, testing will be conducted using sample data for particular compliance issues. This examination continues until the agent is reasonably certain that the information return that has been filed (e.g., Form 5500) and the qualification requirements have been satisfied.

The agent will close the examination by noting any areas that require corrective attention. If there are no issues requiring changes, the case is simply closed and a closing letter is issued. However, if there are issues requiring changes, tax assessments (e.g., income taxes or excise taxes) may be levied and/or the issues may be corrected through Audit CAP. After the corrections have been made, a closing letter will be issued. In the event the employer decides not to correct or will not agree to the corrections proposed in Audit CAP, the IRS may propose revocation and issue a non-qualification letter. The agent’s work is subject to random review by his/her manager to assure technical and procedural accuracy. Any issues unresolved by agreement with the revenue agent may be appealed.

There are currently six desktop guides (e.g., Multiemployer Audit Program (MAP), 401(k), 403(b), 412(i), ESOP, and EP Team Audit) available to IRS revenue agents on the IRS internal website. These have been developed for the EP Exam agents for “one-stop” shopping, serving as a full repository of useful tools, training materials, and links to technical resources. There are three parts to each desktop guide: (1) technical materials (e.g., basic introductions, administrative procedures, and exercises); (2) exam materials such as work papers, procedures, interview techniques, and audit steps; and (3) other resources. The goal of these guides is to enhance uniformity nationwide in the examination processes by having identical resources available for the agents before and during the examination process. They will continue to be useful to the agents to the extent they are updated regularly.

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<sup>16</sup> See Rev. Proc. 2008-50, *supra* note 12, §4.02; Rev. Proc. 2002-9, 2002-1 CB 327, §3.

<sup>17</sup> We understand that this 65% threshold is an informal position.

<sup>18</sup> See Rev. Proc. 2008-50, *supra* note 12, §9.04.

## **D. Methods of Selection for Audited Plans**

In recent years, EP has used four methods to select plans for examination:

- **Special Projects and Abusive Tax Avoidance Transaction (ATAT):**<sup>19</sup> By combining these two methods, the IRS uses historical data and other information (e.g., changes in the law) to select returns. This permits the IRS to respond more easily to emerging issues. These projects are across market segments and apply to all types of retirement plans.
- **Referrals:** These are outside referrals from the EPCU<sup>20</sup> and other IRS operating divisions, as well as from the Department of Labor (DOL). Such referrals uncover very high rates of noncompliance. Sixty-five percent of the referred plans examined in the 2006 fiscal year and 75.7% of the referred plans examined in the 2010 fiscal year were found to be noncompliant.<sup>21</sup>
- **Risk-based targeted examinations:** Risk-based targeted examination is the primary method used by EP to select plans for examination. In the 2001 fiscal year, EP began to use a risk assessment approach based on various market segments and types of retirement plans. This approach was based on historical risk for noncompliance by market segment (e.g., manufacturing) and by type of plan (e.g., profit sharing). From the 2002 fiscal year to 2006 fiscal year, several modifications occurred that reduced the number of market segments, tracked and evaluated noncompliance according to segments, and changed the sampling methods. The IRS reduced the number of market segments based on the percentage of noncompliance and developed a risk-based approach, shifting to only risk-based returns from segments for which significant noncompliance exists either for the entire segment or for parts of the segment.

In the 2006 fiscal year, EP redefined the market segment approach, assigning cases only to certain risk-based segments determined to be the most noncompliant through baseline exam. The IRS analyzed seven different market segments and posted the results on its website—giving the overall assessment of noncompliance within a given segment, detailing

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<sup>19</sup> Internal Revenue Manual 4.32.2.

<sup>20</sup> EPCU is a unique unit under EP Exam that identifies returns for compliance. It uses “soft contact” approaches to question returns.

<sup>21</sup> See *The Employee Plans Function Has Improved the Process for Selecting Retirement Plans for Examination*, Treasury Inspector General for Tax Administration (May 10, 2011), <http://www.treasury.gov/tigta/auditreports/2011reports/201110050fr.pdf>. Using the combined Special Projects, ATAT and referrals methods, EP achieved a change rate that increased from 67% in 2006 fiscal year to 80.4% in 2010 fiscal year. See id.

descriptions regarding the elements of noncompliance, and suggesting actions that plan sponsors could take to avoid noncompliance. There were 7,175 exams, with a 38% change to the return. By the 2008 fiscal year, the IRS had identified 20 different market segments and 11 different plan types.<sup>22</sup> The IRS continues to use these market segments and plan types.

By the 2006 fiscal year, the IRS began a “focus exam” methodology,<sup>23</sup> beginning with three issues that the manager selected for examination, but allowing the agent to expand the audit if sufficient internal controls were not present in the plan’s administration. Agents received special training on performing statistical sampling and manipulating data in electronic databases. New processes and procedures were developed for planning, conducting, and closing audits. The new approach led to an increase in the number of examination returns that closed with a change in return. The percentage of retirement plans identified as noncompliant increased from 42% for the 2006 fiscal year to 53.7% in the 2010 fiscal year.<sup>24</sup>

The term “internal control” is well established in management treatises directed at government entities,<sup>25</sup> as well as private industry.<sup>26</sup> The concept was introduced in 1949 by the American Institute of Accountants (now known as American Institute of Certified Public Accountants or AICPA). Federal agencies have been using it since the passage of the Federal Managers’ Financial Integrity Act of 1982, which required the General Accounting Office to issue standards for internal control in government. Following the passage of the Sarbanes-Oxley Act of 2002,<sup>27</sup> which mandated certain internal controls for publicly traded companies that were designed to improve financial reporting, the federal government reevaluated its policies relating to internal control over financial reporting and management’s related responsibilities. The result was the updated OMB-Circular A-123, Management’s Responsibility for Internal Control, revised December 21, 2004, which provides the specific requirements for assessing and reporting on controls.

Definitions of “internal controls” often begin with a statement similar to this one from the General Accounting Office: An internal control is “[A]n integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial

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<sup>22</sup> See *id.*

<sup>23</sup> Also referred to as a “focused exam” methodology.

<sup>24</sup> See Treasury Report, *supra* note 21.

<sup>25</sup> See, e.g., The Federal Managers’ Financial Integrity Act of 1982, Pub. L. No. 97-255 (1982), which provides the statutory basis for management’s responsibility for assessment of internal control; and the Chief Financial Officers Act (CFO Act) of 1990, which requires CFOs of designated federal agencies including the Department of the Treasury to “develop and maintain an integrated agency accounting and financial management system including financial reporting and internal controls, which . . . complies with applicable . . . internal control standards.”

<sup>26</sup> The seminal work on internal control for private employers was produced by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework*. See <http://www.ic.coso.org/default.aspx> for a recent draft update.

<sup>27</sup> Pub. L. No. 107-204, §§ 302,404 (2002).

reporting, and compliance with applicable laws and regulations.”<sup>28</sup> The Office of Management and Budget offers a similar version: “Internal control is an integral component of an organization’s management that provides reasonable assurance that the following objectives are being achieved: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.”<sup>29</sup> AICPA materials that examine the concept in the context of retirement plans define “internal control” as a “process . . . effected by plan management and other personnel and those charged with governance, and designed to provide reasonable assurance regarding the achievement of objectives in the reliability of financial reporting.”<sup>30</sup>

As stated in section I (**Executive Summary**), we use the term more expansively to include a plan sponsor’s organization, policies, and procedures that are designed to prevent errors in plan administration and to facilitate the discovery and prompt correction of small errors before they become big problems. They are the controls established for the plan in response to identified areas of risk in the plan administrative process.

### **E. Special Audit Unit: EPCU**

The EPCU is a unique unit under EP Exam that identifies returns for compliance enforcement and uses “soft contact” approaches to question returns. While originally a single unit, EPCU has expanded into three groups (each with a manager) for a total of 25 revenue agents, tax compliance officers, computer research analysts, and tax examiners.<sup>31</sup>

The goal of EPCU is to conduct compliance projects (including compliance checks described below), collect data, and perform data analysis to identify areas of noncompliance. Data gathering is accomplished through the use of the Returns Inventory and Classification Systems (RICS), from Form 5500 information, 401(k) questionnaire answers, taxpayers’ W-2s, and Form 1099 data. The data analyst studies the data to identify and target potential audit issues. EPCU compliments EP enforcement efforts by initiating compliance contacts that do not result in full audits. As such, correction of plan defects can still be resolved under the IRS correction program, Employee Plans Compliance Resolution System (EPCRS).

In contrast to a full scope exam, a compliance check is not an audit or investigation under IRC §7605(b), and thus the books and records of the plan are not examined. However, the

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<sup>28</sup> *Standards for Internal Control in the Federal Government*, General Accounting Office, November 1999, p. 5, <http://www.gao.gov/special.pubs/ai00021p.pdf>.

<sup>29</sup> OMB Circular A-123, *Management’s Responsibility for Internal Control*, December 21, 2004, [http://www.whitehouse.gov/omb/circulars\\_a123\\_rev/](http://www.whitehouse.gov/omb/circulars_a123_rev/).

<sup>30</sup> See *Plan Advisory: The Importance of Internal Controls in Financial Reporting and Safeguarding Plan Assets*, AICPA, [http://www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/PlanAdvisories/DownloadableDocuments/Plan\\_AdvisoryInternalControls-lowres.pdf](http://www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/PlanAdvisories/DownloadableDocuments/Plan_AdvisoryInternalControls-lowres.pdf).

<sup>31</sup> EPCU managers include Craig Chomyok in Chicago; Carla Smith in Columbus, OH; and Heidi Child in Ogden, UT.

agent may verify the information on the return filing. Depending on the type of project, a compliance contact letter may be sent by EPCU to a random sample of plan sponsors requesting documentation or clarification on certain issues (e.g., the 401(k) questionnaire sent to 1,200 plan sponsors of 401(k) plans). Alternatively, a compliance contact letter may be sent because information provided by the plan sponsor to the IRS appears suspect, either because clarification is required or the information provided is not typical or average. Ideas for projects come from both internal and external sources. EPCU's priority list is adjusted annually by a Project Selection Committee. For the 2011 fiscal year, the IRS closed 10,000 exam cases in EP and 4,500 EP compliance checks.<sup>32</sup>

## **F. EP Team Audit (EPTA) Program**

EPTA Program is a distinct audit program within EP Exam that focuses only on large case plans (defined as plans with at least 2,500 participants).<sup>33</sup> It uses distinct criteria from the coordinated audit programs, which take into account: the size of the plan, certain risk factors, information from the media, industry trends, and information from the Form 5500 filings. While these plans comprise less than 1% of the overall plans, they cover approximately 60% of the plan participants and hold approximately 70% of the overall plan assets. While the mistakes found in these plans are similar to those found in smaller plans, noncompliance in larger plans is more costly and could affect more participants. This unit conducts over 100 EPTA audits annually. There is a Taxpayer Documentation Guide (TDG) for EPTA for Large Case Revenue Agents that provides an extensive list of the documents needed for the agent to review a plan under examination.

EPTA in the Pacific Coast Region recently completed a pilot program of a revised approach to EPTA. The Pacific Coast was in a unique position to conduct a pilot program as it had recently hired new personnel who could observe the EPTA program with "fresh eyes." The EPTA pilot continued to make selections of exam issues based on risk analysis, but expanded the analysis to include an assessment of the plan's internal controls, particularly those that are system based. Hence, the scope of audit was not defined until all significant facts of the sponsor's internal controls regarding the plan had been ascertained. Importantly, this focus goes beyond identification and correction of past errors to include an examination of the systems that could have caused those errors.

According to EPTA, sufficient plan internal controls are characterized by:

- segregation of duties within the sponsor's various functions (e.g., payroll, accounts payable, general ledger, and human resources),

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<sup>32</sup> See <http://www.irs.gov/retirement/article/0,,id=171015,00.html>.

<sup>33</sup> See <http://www.irs.gov/retirement/article/0,,id=129221,00.html> for a list of recent EP projects.

- systems including payroll, human resources, and plan operations (e.g., plan entry, benefit accruals, distributions, and plan assets) established to verify that data and processes are consistent with plan provisions,
- books and records maintained by responsible personnel knowledgeable of the sponsor's business and the daily operations of the plan,
- responses to an agent's interview questions that are complete and accurate by responsible personnel, and
- Form 5500 returns that are filed timely and accurately, and can be reconciled to the books and records of the plan.

Under the pilot program, the IRS agents performed extensive pre-audit screening and on-site interviewing of personnel from information technology, payroll, and HR. Based on these results, the scope of the audit could be expanded or contracted. In the past, the role that processes played in the plan's operations was not as predominant. The new approach was useful in situations where large employers used systems that crossed multiple plans within the controlled group. If the internal controls were reliable, there was less risk for noncompliance by multiple plans. Due to economies of scale, this approach improved the efficiency of the audit.

EPTA in the Pacific Coast's pilot program used an internal control questionnaire in which the revenue agent asked questions regarding the seven main areas of the plan's operation: plan qualification issues, plan administration, participation and eligibility, accountings and deductions, distributions, trust assets, and disclosure. The answers to the internal control questionnaire were used by the agent to understand the responsibilities and coordination needs to keep the plan and trust in compliance.

## **G. Results of the Pilot Program**

The IRS has discovered that the similarities in the internal controls for plans are greater than the differences, even throughout a diverse cross-section of organizations. It appears that identified operational weaknesses exist commonly across a variety of plan sponsors as internal controls typically cross all of the sponsors' employee groups. Therefore, the IRS's investigations into an organization's internal controls result in a more significant "touch" during its enforcement efforts.

The agents observed that most large employers are now outsourcing plan administration to contain plan costs, thereby eliminating the need for a senior skilled internal benefits manager to oversee the plan. By outsourcing, the plan sponsors assumed that they had delegated certain responsibilities for the plan's administration to the third party service provider.

However, as a result of this pilot program, the IRS has discovered a significant “disconnect” between the allocation of responsibilities between the plan sponsor and the service providers, thereby prompting the IRS agents to provide more education for sponsors as to their responsibilities under the plan. The pilot program also showed that record retentions by service providers varied tremendously. These results were similarly confirmed with the results of the recent 401(k) questionnaire that indicated that internal controls are at the root of many of the most frequently identified plan noncompliance issues. The IRS has decided to expand this pilot program nationwide.

For a detailed description of EP, and its role within the TE/GE division of the Internal Revenue Service, see Appendix B.

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### III. Assessment of Existing Materials on Internal Controls from the Perspective of Plan Sponsors and Outside Service Providers

The 2011 ACT Report of Recommendations described the extensive library of resources the IRS has developed as part of its CE&O efforts. These resources include Checklists,<sup>34</sup> Fix-It Guides,<sup>35</sup> the Internal Revenue Manual (IRM),<sup>36</sup> and other publications. The ACT recommends that the Service review all existing materials and adapt them for use throughout all of EP's functional areas to emphasize the importance of internal controls in maintaining compliant plans. In addition, the development of future materials should incorporate a cross-functional review to maximize their utility across the organization and eliminate redundancies.

#### A. Reasons for Recommendations

1. **Consistency** – Adapting materials for use across all EP functional areas will create consistency of messaging internally to Service personnel and externally to the plan sponsor and practitioner communities, leading to enhanced compliance. For example, CE&O could continue to promote the Fix-It Guides as part of its outreach, while EP Exam could include links to the same Fix-It Guides as part of audit opening letters or IDRs (see discussion below at section D). Although many failures can no longer be corrected through the VCP once a plan is under examination, certain insignificant failures can still be corrected via SCP.<sup>37</sup> In addition, providing sponsors with resources that illustrate the types of corrections the Service prefers may reduce their “fear of the unknown.”
2. **Efficiency** – The Service can more efficiently maintain a single, centralized resource library so that updates are made one time and are disseminated on a timely basis to all users, both internal and external. This will leverage limited resources, by reducing the time required for drafting, and provide quality assurance.
3. **Collaboration** – Provision of uniform and consistent materials will engender a more collaborative environment between EP Exam, plan sponsors, and practitioners by removing some of the perceived mystery from the examination process.

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<sup>34</sup> See <http://www.irs.gov/pub/irs-tege/pub4531.pdf>.

<sup>35</sup> See <http://www.irs.gov/retirement/sponsor/article/0,,id=181908,00.html>

<sup>36</sup> See <http://www.irs.gov/irm/index.html>.

<sup>37</sup> See Rev. Proc. 2008-50, *supra* note 12, §8.01.

4. **Scalability** – Although various segments of the plan sponsor community that differ by size, location, industry, and etc., have different needs and levels of resources available, all can benefit from the establishment of best practices and internal controls designed to improve operational compliance. All current and future materials can be adapted so that they are scalable for use.

## **B. Integration of Internal Controls into IRS Process and Materials**

For plan sponsors or outside service providers (i.e., third party administrators and record keepers) of small to midsize 401(k) retirement plans seeking IRS resources that address best practices with respect to maintaining a compliant 401(k) plan, the IRS website offers tools such as the 401(k) Plan Checklist,<sup>38</sup> the IRS 401(k) Fix-It Guide Table,<sup>39</sup> the 401(k) Plan Overview,<sup>40</sup> the EPCRS Overview,<sup>41</sup> Questions concerning what the IRS considers the most common compliance issues facing 401(k) plans (with find, fix, and avoid errors subsections) (the “Questions”),<sup>42</sup> and the 401(k) questionnaire (the “Questionnaire”).<sup>43</sup> Of all these resources, the Questions provide not only the broadest range of systems procedures most useful in preventing common 401(k) compliance failures, they also have the most practical tips for implementing such procedures.

When visiting the home page of the IRS website, [www.irs.gov](http://www.irs.gov), a plan sponsor, or outside service provider can choose from a variety of links that lead to these internal controls resources. The IRS has placed large, readily visible tabs, geared towards the various communities it serves, at the top of its home page. A perusal through this band of tabs allows a plan sponsor/outside service provider to choose the “Retirement Plans Community” (RPC) tab,<sup>44</sup> which then leads to a screen that categorizes the information and resources available by topic. This screen provides the visitor with the option of choosing the “Fix-It Guides – Common Problems, Real Solutions” (find, fix, and avoid common mistakes in plans),<sup>45</sup> or the “Site Map” (comprehensive list of information by topic).<sup>46</sup> Each of these links leads to the 401(k) internal controls tools, which can be found grouped together in a 58-page document under the heading “401(k) Plan Checklist.”<sup>47</sup> Those plan sponsors/outside service providers that are unfamiliar with these resources can access the same tools through the “Plan Sponsor/Employer,” or “Benefits Practitioner” links for added ease and convenience.

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<sup>38</sup> See IRS Publication, *supra* note 34.

<sup>39</sup> See IRS Article, *supra* note 6.

<sup>40</sup> See IRS Publication, *supra* note 34.

<sup>41</sup> See *id.*

<sup>42</sup> See *id.*

<sup>43</sup> See [http://www.irs.gov/pub/irs-tege/epcu\\_401k\\_questionnaire.pdf](http://www.irs.gov/pub/irs-tege/epcu_401k_questionnaire.pdf).

<sup>44</sup> See <http://www.irs.gov/retirement/index.html>.

<sup>45</sup> See *id.*

<sup>46</sup> See *id.*

<sup>47</sup> See IRS Publication, *supra* note 34.

Service resources should be updated to incorporate internal control concepts throughout, where applicable. For example, the list of the Top 10 Failures<sup>48</sup> on the website could be expanded to include the types of controls sponsors could consider to reduce the potential of encountering those failures. EP Exam could lead this effort and share its findings with other functional areas within EP.

Each question in the 401(k) Checklist<sup>49</sup> has a subsection entitled “**How to Avoid the Mistake:**,” which provides a brief, bullet-point list of the most significant best practices and procedures to avoid the specific 401(k) compliance issue being addressed. When these subsections are taken collectively, they provide the plan sponsor/outside service provider with a panoramic user-friendly snapshot of those internal controls that, if lacking or inadequate, will be primarily responsible for the most common 401(k) retirement plan compliance failures. These internal controls consist of systems procedures in connection with plan administration, human resources personnel, payroll, and recordkeeping.

### **Questions Enhanced to Convey Best Practices:**

In light of the value that these “avoid the mistake” subsections offer plan sponsors and outside service providers of small to mid-size 401(k) retirement plans, the ACT recommends bolstering this resource with additional best practices information described below. The additions will maximize the knowledge base that this tool may provide for plan sponsors and outside service providers who may not have the financial wherewithal or the human resources to expend on implementing additional systems procedures.

1. Has your plan document been updated within the past few years?

How to avoid the mistake:

- Perform an annual review of your plan document.
- Identify a person responsible for: determining when time-sensitive plan amendments must be adopted, and informing all relevant parties when regulatory changes will impact the plan and require amendments. Use a calendar (tickler file) that notes when you must complete amendments.
- Make sure your plan document and Summary Plan Description or Summary of Material Modifications, as relevant, match. If you amend your plan document, check the language against the old plan document, noting any differences. Have a centralized person or department responsible for maintaining all plan documents.

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<sup>48</sup> As noted in last year’s report, the website is a more static design. As such, we have tried to use the same language as used on the existing materials.

<sup>49</sup> See IRS Publication, *supra* note 7.

Make certain that amendments are readily available for all plans including those transferred, merged, spun-off, or transferred in a trust-to-trust transfer to the plans—back to the later of the last determination letter issued directly to the employer or to inception.

- Maintain contact (on at least a yearly basis) with the outside professionals, who have drafted the plan documents, or the service provider that sponsors or sold your company the prototype or volume submitter plan documents. If the service provider, bank, or law firm sends a set of amendments to formally adopt, make certain that it is timely executed per the sender's instructions. Keep signed and dated copies of all plan documents and any amendments for your records. Knowing you have properly updated your plan may not be a simple process. Certain plans must be individually amended for each change, while others may have a prototype document that is amended by the external service provider.

2. Are the plan's operations based on the terms of the plan document?

How to avoid the mistake:

- Be sure to apply the provisions of the plan correctly when making a determination of what contributions or benefits are provided to participants. Develop a communication mechanism to make plan administrators and outside service providers (outside plan consultant, actuary, and/or third party administrator/record keeper) aware of changes on a timely and accurate basis.
- Have a clear process for making distributions, which includes the plan's procedures for ensuring appropriate authorization, accuracy, and timeliness. Have an identified team in place responsible for oversight of payments.
- Put in place protocols and an action plan for use when errors are identified including the appropriate actions to resolve such errors.
- Identify the trustees of the plan as well as the procedures for tracing cash contributions and agreed-to receipts by the trust custodian.
- Clearly identify the custodian of trust assets including the procedures for maintaining trust asset data, communication mechanisms for transferring trust asset data to the trustee, and the reconciliation process including how errors are dealt with.

3. Is the plan's definition of compensation for all deferrals and allocations used correctly?

How to avoid the mistake:

- Perform annual reviews of the plan's operations.
  - If the plan document is amended, check the definitions against the old document, noting any differences. Have a centralized person or department responsible for maintaining all plan documents.
  - If you amend your plan document, communicate those changes to everyone involved in the plan's operations. Plan sponsors should develop an internal communication mechanism to advise plan administrators and outside service providers (outside plan consultant, actuary, and/or third party administrator/record keeper) of changes on a timely and accurate basis.
  - Provide proper training of in-house personnel in charge of determining compensation to understand the plan document.
  - Know what your third party administrators have agreed to provide for you. They may be relying on you for information, such as compensation and deferral amounts used in their work. Retain a copy of your third party administrator service contract including any updated contracts; and keep a summary of what is being supplied to the plan by the third party administrator, actuary, or consultant. Keep this service contract and summary with the person responsible for maintaining all plan documents.
  - To the extent possible, simplify your plan's definition of compensation and use the same definition for multiple purposes.
4. Were employer matching contributions made to all appropriate employees under the terms of the plan?

How to avoid the mistake:

- Be familiar with your plan document's terms; and implement procedures to ensure that your plan operates according to your plan document.
- Work with your plan administrators to ensure they have sufficient employment and payroll information to calculate the employer matching contribution described under the plan document's terms.
- Identify: payroll services performed in-house, or outside services used; and how payroll is communicated to other in-house staff or outside service providers servicing the plan. Identify who is in charge; and identify his/her responsibilities.

- Know how deferrals, loans, QDROs, or other deduction payments are remitted.
- Be familiar with the procedures for how payroll errors are corrected, how corrections are communicated to the plan administrator, and how records of any corrections are maintained.

5. Has the plan satisfied the 401(k) nondiscrimination tests (ADP and ACP)?

No changes recommended.

6. Were all eligible employees identified and given the opportunity to make an elective deferral election (exclusion of eligible employees)?

How to avoid the mistake:

- Review your plan document for the definition of “employee” and/or provisions relating to employee eligibility.
- Provide proper training of in-house personnel in charge of determining employee eligibility so personnel fully understand the plan document.
- Inspect your payroll records to extract the total number of employees, birth dates, hire dates, hours worked, and other pertinent information. Also inspect Form(s) W-2 and state unemployment tax returns and compare employee data on these records with the payroll records to see if employee counts are accurate.
- Establish protocols and an action plan that will be triggered when errors are identified including the appropriate actions to resolve such errors.

7. Are elective deferrals limited to the amounts under IRC §402(g) for the calendar year and have any excess deferrals been distributed?

How to avoid the mistake:

- Work with your plan administrator to ensure that the administrator has sufficient payroll information to verify that the deferral limitations of IRC § 402(g) were satisfied.
- Establish procedures to ensure that, based on the participant election forms (including modifications), participants will not exceed the IRC § 402(g) limit.
- Have checks and balances in place to alert you and your plan administrator when the limit is exceeded so that timely corrective action can be taken.

8. Have you timely deposited employee elective deferrals?

How to avoid the mistake:

- Establish a procedure that requires elective deferrals to be deposited coincident with or after each payroll according to the plan document. If deferral deposits are a week or two late because of vacations or other disruptions, keep a record of why those deposits were late.
- Coordinate with your payroll provider and others who provide service to your plan, if any, to determine the earliest date you can reasonably make deferral deposits. The date and related deposit procedures should match your plan document provisions, if any, dealing with this issue.
- Implement practices and procedures that are communicated to new personnel, as turnover occurs, to ensure incoming personnel has a full understanding of when deposits must be made.

9. Do participant loans conform to the requirements of the plan document and IRC § 72(p)? Did the plan make loans to individuals who are disqualified persons? If yes, are the loans prohibited transactions under IRC § 4975?

No changes recommended.

10. Were hardship distributions made properly?

No changes recommended.

11. If the plan was top-heavy, were the required minimum contributions made to the plan?

How to avoid the mistake:

- Perform a top-heavy test annually.
- Take care to properly identify ownership interests under the family aggregation rules so that the test is accurate. Be especially careful if you have a smaller plan or one that only covered owners for a period of time and now has other participants.

12. Have you filed a Form 5500-series return; and have you distributed a Summary Annual Report (SAR) to all plan participants this year?

How to avoid this mistake:

- Understand your responsibilities to file the return. The plan administrator has the responsibility for making certain the return is timely filed. Never assume someone else is filing the return for you.
- Make an identified person or outside service provider responsible for timely filing the return.
- Use a calendar (tickler file) that notes the deadline for filing the return; and implement a communication mechanism to alert the plan administrator and any outside service providers of the upcoming deadline to file.<sup>50</sup>

### **C. The 401(k) Questionnaire**

The 401(k) Questionnaire, available on the IRS website,<sup>51</sup> requires that a plan sponsor or outside service provider answer various questions concerning plan demographics, plan participation, employer and employee contributions, top-heavy and nondiscrimination rules, distributions and plan loans, plan operations, automatic contribution arrangements, designated Roth features, and plan administration. A small portion of the Questionnaire is geared towards assisting plan sponsors or outside service providers achieve greater 401(k) plan compliance by identifying, replacing, and/or implementing effective systems procedures. With the exception of plan administration, the Questionnaire fails to raise any questions that would elicit information concerning a plan sponsor's or outside service provider's practices in connection with human resource personnel, payroll, and recordkeeping systems.

In an effort to make the Questionnaire a true "internal control tool" for 401(k) retirement plans, the ACT recommends incorporating the questions used in each of the HR Personnel, Payroll, Plan Failures, and Plan Administration EPTA Program – Internal Control Questionnaires<sup>52</sup> into the 401(k) Questionnaire (either as part of an updated 401(k) Questionnaire or as a newly titled questionnaire). As the Internal Control Questionnaire screen page correctly indicates, each set of questions provides a guide that will help plan sponsors and administrators understand the responsibilities and coordination needed to keep a qualified plan and trust in compliance with the tax laws. At the same time, it will allow EP examiners the opportunity to gain an understanding of the system procedures and internal controls being utilized by a retirement plan.

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<sup>50</sup> See IRS Publication, *supra* note 34.

<sup>51</sup> See IRS Publication, *supra* note 43.

<sup>52</sup> See <http://www.irs.gov/retirement/article/0,,id=206492,00.html>.



## **D. Substantive Recommendations**

1. **Opening Letter** – The initial contact letter should describe the process and set expectations in plain, nontechnical language. It should identify the specific areas of focus and highlight the importance of internal controls. This could be facilitated by providing links to relevant materials on the IRS website including information the sponsor can use to prepare for the audit.

The sponsor should be asked to provide two key documents: a list of key plan contacts (e.g., human resources, payroll, and information technology to ensure the most appropriate parties are included at the proper times to expedite the review and minimize the disruption to the plan sponsor's business); and the core plan documents. No other documents should be formally requested as part of the opening letter; however, it should include a brief list of the types of documents that will eventually be requested.

The opening letter should conclude by requesting an introductory phone call between the auditor and the relevant plan sponsor representatives to discuss the exam process and answer any questions.

A sample opening letter is included as Appendix C. Sample IDRs for gathering key contact information (Appendix D) and core plan documents (Appendix E) could be enclosed in the opening letter. Appendix F incorporates a sample IDR in which the agent requests a description of the plan's update process. This IDR would be sent in a later communication rather than in the opening letter.

2. **Initial Phone Conversation** – The primary purpose of the pre-examination phone conference is to have the auditor explain the scope of the examination and answer any questions the plan sponsor has regarding expectations. During the call, the sponsor should be asked to articulate the roles and responsibilities of each of the key contacts provided in response to the opening letter request. The auditor should make the sponsor aware of the forthcoming IDR(s) and emphasize the importance of prompt compliance. The call should be concluded by establishing a proposed timeline for the remainder of the examination.
3. **IDRs** – Early stage IDRs should be presented in grid format with a brief description of each item requested as well as a link to expanded information including the internal controls involved on the IRS website. If a focused exam, greater emphasis should be placed on the internal controls specific to the area(s) of focus. A link to the IRM on the website should

also be included. The IDR should include language instructing the sponsor to contact the auditor with any questions about the applicability or relevance of any of the requested documents.

4. Resolution of Internal Control Issues

- a. EPCRS includes at least one example of the Service not pursuing otherwise applicable penalties when a plan sponsor performed its duties, but did not fully correct a failed nondiscrimination test due to reliance on inaccurate data.<sup>53</sup> Similarly, the ACT recommends that where a plan sponsor has taken affirmative steps to establish internal controls, but an error occurs as a result of a deficiency in those controls, the Service should reduce the otherwise applicable sanctions. The auditor should be granted some degree of discretion to recommend a reduction of the sanctions based on the strength of the internal controls observed during the examination.
- b. When a failure of internal controls occurs and is discovered as part of an examination, the Service should provide remediation materials to the sponsor that suggest general process improvements, rather than substantive fixes, to prevent recurrence of the failure.

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<sup>53</sup> See Rev. Proc. 2008-50, *supra* note 12, §6.09(4).

## **IV. Conclusion**

This year, the EP subcommittee focused on the role of internal controls in the administration and governance of retirement plans. Through one pilot program tested on large plans, EP Exam has confirmed the effectiveness of a plan sponsor's use of internal controls as an indicator of whether a plan is likely to be found noncompliant on further examination. This has allowed EP Exam to leverage resources that have been diminished by budget cuts and buy outs by increasing the efficiency of its process for selecting plans for audit. It also has allowed auditors to limit the scope of those audits to plan administrative functions and/or systems that show weaknesses, which means plan sponsors benefit from shorter, less disruptive examinations.

The discovery of weak or even nonexistent internal controls offers other benefits in addition to more efficient identification of noncompliant plans. It also can create a potential teaching moment because an examination focused on internal controls will detect the probable cause of a compliance problem as well as the solution. A plan sponsor facing penalties for noncompliance is likely to be motivated, with guidance by the examiner, to look at website materials that will help the sponsor reduce or even prevent future compliance problems. That outcome is in line with EP Exam's mandate.

The ACT recommends providing a consistent message across all EP functions that reinforces the importance of strong internal controls for plan administrative functions. The substance is already there in many of the excellent communication materials the IRS has developed for plan sponsors, but it needs to be made more explicit with specific references to internal controls and best practices. For efficiency, the same materials can be cross referenced to make them relevant to many different audiences including employers considering whether to establish a retirement plan, a plan sponsor feeling overwhelmed by the complexity of maintaining a plan, an employer receiving IDRs in the course of an audit, and a plan sponsor regrouping after an audit that has uncovered noncompliance.

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## **Appendix A: Establishing and Maintaining Adequate Internal Controls – Process Steps for Plan Sponsors**

This Appendix contains process steps that plan sponsors might consider when working to establish and maintain adequate internal controls with respect to:

- updating plan documents and related participant materials,
- determining contributions based on the proper definition of plan compensation,
- determining eligibility for plan participation,
- establishing communication and data flow between plan sponsors and outside service providers,
- ensuring adequate plan record retention practices, and
- confirming that all plan fiduciary and management responsibilities are assigned and executed.

These process steps are general in nature. Accordingly, actual best practices may vary from plan to plan.

### **1. Process for Updating Plan Documents and Related Participant Materials**

The most common failure reported to the IRS through its VCP is the failure by plan sponsors to amend their plan documents for tax law changes prior to the end of the period required by law.

It is also important that voluntary amendments, that the plan sponsor desires to make (i.e., those not required by law), be prepared and adopted prior to the period required for the amendment to become effective at the desired date.

In order to assure that amendments are prepared and adopted timely, a plan sponsor<sup>54</sup> might establish a process to:

- define the desired or required compliance change to be made to the plan,
- determine the deadline for adoption and execution of the plan amendment,

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<sup>54</sup> We note that, depending on the structure of each plan, certain obligations that are referred to as plan sponsor obligations throughout this report may be duties that are the responsibility of a plan fiduciary (e.g., a plan administrator that is not the plan sponsor) rather than a plan sponsor itself.

- determine the deadline for distribution of the Summary Plan Description (SPD) or Summary of Material Modification (SMM), if required,
- identify and communicate changes that will be needed to the affected internal operations personnel,
- identify and communicate changes to affected outside service providers, and
- establish process for the proper adoption and execution of plan documents, and retain signed and dated copies of plan documents and amendments indefinitely.

As Congress passes new legislation, it is important for plan sponsors to be aware of the impact it has on the plan as well as the timeframe that is allotted to draft and execute plan amendments. Prototype and other preapproved plans may be amended by service providers that maintain the plan document. Plan sponsors should regularly ask their service providers about required changes to plan documents and the deadlines for amending.

Plan sponsors should follow the term of the plan with respect to amending the plan document. The document will detail the plan's adoption procedures for plan amendments and identify individuals or group of individuals who are authorized to adopt and execute the plan document.

A plan sponsor might also establish a process to review the amendments to the plan, compare the changes to the language in the plan's SPD or SMM, as the case may be, and make appropriate changes to the SPD and/or SMM. A plan sponsor should also make appropriate amendments to the plan document when the plan's operation is changed.

Plan sponsors should also perform due diligence on plan documents for plans that are involved in merger situations, as the merger of plans into other plans can cause disqualification of both plans if the merged plans are not timely amended for applicable laws prior the merger.

## **2. Determination of Contributions Based on Definition of Plan Compensation**

It is important that a plan sponsor be aware of and understand the amount of compensation that a plan uses to determine contributions. Failure to use the correct amount of compensation to determine participants' contributions to the plan can result in participants receiving contributions to their accounts that are either greater than or less than the amount they should receive.

Certain types of compensation may be included or excluded from the plan's definition of compensation, such as bonuses, commissions, overtime pay, and taxable fringe benefits.

In order to assure that each plan participant's compensation is properly determined, the plan sponsor might establish procedures to:

- review the plan document to make sure that the plan's definition of compensation correctly reflects the plan sponsor's intent,
- review the plan sponsor's payroll system(s) to identify which items of compensation on the payroll system are included in the plan's compensation definition and which are excluded,
- maintain a checklist of all payroll items which indicates whether the item is included or excluded in the plan's definition of compensation,
- test plan contributions that are calculated by the payroll system to determine that contributions are based on the proper amount of compensation for the period being tested,
- test plan contributions that are calculated by the payroll system to determine that contributions are limited to the 401(a) (17) limitation on compensation for the current year (Establish procedures for annual changes to the required limit.), and
- for plan contributions that are not calculated by the payroll system, test plan compensation that will be used by the plan's administrator to determine contributions to make sure the contribution is based on the proper amount of compensation for the period being tested.

It is important for proper operation of the plan that the plan sponsor's payroll system properly reflect all types of compensation that are included in plan compensation and all types of compensation that are not included in plan compensation when determining salary deferral and employer matching or nonelective contributions. Steps a plan sponsor's payroll department might take include maintaining worksheets which detail the calculation of plan compensation and contributions, and routinely checking payroll information that is being used to calculate plan contributions.

If simplicity is desired, a plan sponsor might consider using a uniform definition of compensation, if possible, for all purposes under the plan including determination of contributions and compliance testing. If the plan uses a different definition of compensation for each purpose, the plan sponsor should take extra care to make sure that payroll personnel are aware of the various definitions of plan compensation, and that the compensation amounts that are used for compliance testing are carefully reviewed each year before the annual tests are performed.

### **3. Determination of Plan Eligibility**

The failure of the plan sponsor to include eligible employees in the plan or to exclude ineligible employees from the plan is a very common operational failure. In the case of a 401(k) plan, employees must be properly enrolled when they first satisfy the plan's eligibility requirements so they can elect to make plan contributions. If employees are not properly identified as eligible plan participants, they cannot contribute to the plan until the mistake is corrected. These errors can be very costly to the plan sponsor.

In order to assure that plan eligibility is properly determined, the plan sponsor might establish one or more procedures to:

- identify all eligible and ineligible classes of employees of the plan sponsor (Identify any exclusions of employees from eligible classes of employees (e.g., owners).),
- identify age and service requirements for eligible classes of employees,
- calculate service periods and hours worked, if required, based on the plan document's definition of service,
- establish a process for providing required enrollment instructions, disclosure notices, and election forms to employees within required notification timeframes,
- establish a process for enrolling eligible employees on the payroll system,
- establish a process for determining eligibility for rehired employees, and
- establish a process for determining eligibility for employees who transfer employment to another eligible or ineligible employment class.

In addition, payroll systems should be checked to make sure that the number of hours each employee works can be properly tracked for each employee for purposes of determining plan eligibility, if necessary.

Special procedures might also be established for rehired, part-time, and leased employees to ensure that they are properly enrolled when eligible for the plan. Rehired employees may be eligible to reenter the plan immediately upon their reemployment; and care should be taken to understand their eligibility dates following reemployment. Part-time and leased employees must be eligible to participate in the plan in accordance with IRS rules, and should not be identified as ineligible on the sponsor's HR or payroll systems even if they are ineligible for other benefits.



Plans that provide for automatic enrollment must establish a process to enroll employees by default if no affirmative enrollment election is received.

The plan administrator might also establish special procedures for determining eligibility for employees acquired through a business transaction or transferred to or from other affiliates of the plan sponsor.

#### **4. Establishment of Communication and Data Flow with Outside Service Providers**

The IRS has confirmed through its audit process that errors and omissions in plan operation are frequently the result of miscommunication or confusion surrounding information that is provided between the plan sponsor and its outside plan service providers. When the plan sponsor shares responsibilities for plan operations with outside service providers, it is important that the sponsor maintain a clear overview of the plan's overall operation; and that each party understands his or her respective roles and responsibilities.

In order to assure that communication and plan data is shared and processed accurately and timely, the plan sponsor might establish one or more processes to:

- identify what information needs to be shared,
- identify the specific purposes for which the shared information will be used by each party,
- identify when the information will be provided,
- perform an initial test of the process,
- perform an independent test of the process periodically, and
- modify any of these processes when necessary (e.g., plan amendment, technology upgrades, and personnel changes).

Examples of information that might be shared, parties responsible, and the purpose of providing the information include:

INFORMATION	PROVIDE TO/FROM:	PURPOSE FOR INFORMATION
<b>Employment Data</b>	Plan Sponsor/ Payroll Vendor	Calculation of Salary Deferral/ Matching Contributions
	Plan Sponsor/ TPA Record Keeper	Vesting and Distributions
<b>Contributions</b>	Payroll Vendor/ TPA Record Keeper	Participant Recordkeeping
<b>Loan Schedules</b>	TPA Record Keeper/ Payroll Vendor	Establish Repayments for Plan Loans
<b>Payroll Data</b>	Payroll Vendor/ TPA Record Keeper	Compliance Testing
<b>Compliance Testing</b>	TPA Record Keeper/ Trustee	Corrective Distributions

The plan sponsor should obtain written agreements with its outside service providers to document the roles and responsibilities of each party. If possible, the agreement should require that providers review the information provided to them for reasonableness when performing their services.

The information flow and plan operations should be documented to provide the plan sponsor a roadmap: to assist individuals involved in plan operations and oversight; and for use in training new employees when there is turnover of personnel.

## **5. Establishment of Adequate Plan Record Retention Practices**

The IRC and Treasury Regulations require that plan sponsors keep books and records available for inspection by the IRS.<sup>55</sup> In addition, under the Employee Retirement Income Security Act (ERISA) of 1974, employers are required to keep records sufficient to determine benefits due or which may become due.<sup>56</sup>

The plan sponsor has the responsibility to retain records and to preserve the ability to access, retrieve, and deliver those records (including electronic records) in response to a request during audit.

Plan sponsors should understand the applicable timeframe for maintaining records, and establish plan records retention procedures accordingly. Plan records need to be available:

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<sup>55</sup> See <http://www.irs.gov/retirement/article/0,,id=206493,00.html>.

<sup>56</sup> 29 U.S.C. §§107,209.

- to provide to the IRS and the Department of Labor (DOL) in the case of audit, and
- for purposes of determining benefits of plan participants.

During the relevant period,<sup>57</sup> all plan administration records including allocation reports, compliance tests, 5500 forms (with schedules and any amendments), trust reports, and 1099-R forms should be maintained by the plan sponsor.

Other documents that may be needed in an audit or to investigate benefit claims include:

- dated and executed copies of the plan document, and the actions taken to adopt the plan (e.g., corporate resolution), and signed and dated copies of all plan amendments,
- copies of employee communications including the plan's SPD, the SMM that describes plan amendments, and other types of communications that explain the benefits provided,
- the most recent determination letter,
- evidence of a fidelity bond,
- demonstrations of compliance with all applicable coverage and nondiscrimination tests including supporting documentation that confirms compliance,
- applications to IRS correction programs, and
- resolutions to governmental inquiries.

Thorough documentation of plan participant accounts including historical contributions, hours worked, and account balances should be maintained for purposes of determining and verifying benefits of plan participants that may be paid out in future years.<sup>58</sup>

When the plan sponsor utilizes outside service providers, such as payroll providers or third party administrator/record keepers, the plan sponsor should evaluate if and how to incorporate its plan records retention needs into the agreements with those service providers. A plan sponsor might also consider whether any obligations should remain in force after the termination of a service provider's agreement.

Plans that are acquired through business transactions may require historical records if former employees are retaining accounts under the acquired plan. Plan sponsors should perform their

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<sup>57</sup> The length of time that materials need to be retained will vary by type of record. See <http://www.irs.gov/businesses/small/article/0%2C%2Cid=98513%2C00.html>. Generally, claims related to IRS and DOL filings are subject to a statute of limitation. The requirement to retain records is not necessarily of indefinite duration. See *Roarty v. AFA Protective Sys., Inc.*, No. 06 CV 0152, 2008 WL 4455588 (E.D.N.Y. Sept. 30, 2008).

<sup>58</sup> See id.

due diligence on acquired plans to determine their records retention needs and make efforts to obtain those records if necessary.

## **6. Assignment and Execution of Plan Fiduciary and Management Responsibilities**

Although the exact framework of each plan's fiduciary structure and allocation of management responsibilities is likely to vary from plan to plan, there are several key items that should be evaluated when designing and implementing a fiduciary structure.

First, the plan fiduciary structure—from named fiduciary to committee and/or other structures—should be clearly identified in the plan document. In addition, key operational documents, such as plan administrative manuals with record keepers and providers, should be reviewed to ensure that they are both consistent with the plan and reflect the sponsor's intended structure.

Second, an important management practice is to ensure that the plan fiduciaries have a means to maintain an ongoing understanding of their duties under IRS, DOL, and any other relevant agency guidance. While key support in these areas can be provided by outside advisors, it is important for plan fiduciaries to keep in mind their central role in this process.

Third, plan fiduciaries should actively review and monitor their service agreements. The vetting and ongoing review of the plan's service providers can be aided by outside advisors, but it is important for the plan fiduciaries to ensure that they have reviewed the services, qualifications, and fees for each of their advisors—including any advisors who would help evaluate other advisors. With the upcoming effective dates of the DOL's fee disclosure guidance under sections 404(a) and 408(b)(2),<sup>59</sup> plan fiduciaries should also consider establishing a regular timeline for completing these reviews.

Fourth, plan fiduciaries should play an active role in the process for selecting and monitoring investment advisors and/or options. While outside advisors can again play a key role, plan fiduciaries will usually retain at least some responsibility for the selection and review of investments, and should have a process for fulfilling their duties in place.

These four items are intended to serve as examples of baseline activities to consider when establishing a fiduciary structure and assigning management responsibilities. Notably, the DOL already provides significant resources for plan fiduciaries that can also be looked to help determine the best practices relevant to each plan's fiduciary and management responsibilities.<sup>60</sup>

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<sup>59</sup> See <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=25781&AgencyId=8&DocumentType=2> and <http://webapps.dol.gov/FederalRegister/HtmlDisplay.aspx?DocId=24323&AgencyId=8&DocumentType=2>.

<sup>60</sup> See <http://www.dol.gov/ebsa/fiduciaryeducation.html>.

## **Appendix B: Background on EP within the TE/GE Division**

The IRS falls within the Department of the Treasury. Since its reorganization in 2000, the IRS has four main operating divisions: Wage and Investment (W&I); Small Business/Self-employed (SB/SE); Large Business & International (LB&I); and Tax-Exempt and Government Entities (TE/GE).<sup>61</sup> The latter division was established in 1999 in conjunction with the IRS's modernization efforts. It replaced the former Assistant Commissioner (Employee Plans and Exempt Organizations) function established as a result of the passage of the ERISA.

TE/GE's mission is "To provide Tax Exempt and Government Entities customers top quality service by helping them understand and comply with applicable tax law and to protect the public interest by applying the tax laws with integrity and fairness to all."<sup>62</sup> Its focus is customer oriented. It services three different customer segments:

- Employee Plans (EP),
- Exempt Organizations (EO), and
- Government Entities (GE). The GE segment is further divided into three entities: Federal, State & Local Governments; Indian Tribal Governments; and Tax Exempt Bonds.

While these five "stove pipes" within the three segments have different needs, missions and perspectives, there is crossover of issues between them which provides TE/GE with additional leverage to parlay good ideas from one segment over to another segment.

TE/GE also addresses four basic key customer needs:

- CE&O,
- Rulings and Agreements (R&A),
- Examinations, and
- Customer Account Services.

TE/GE is different from the other main operating divisions due to the following reasons: the public nature of its tax filings make its operations more transparent; the balancing nature

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<sup>61</sup> Prior to the modernization efforts in 2000, the IRS was divided according to geographic region. The IRS Restructuring and Reform Act of 1998 (RRA '98) was passed in reaction to the wide range of problems facing the IRS (e.g., inadequate technology; lack of training and resources).

<sup>62</sup> See <http://www.irs.gov/irs/article/0,,id=100971.00.html>.

between a regulatory approach versus revenue approach; and the fact that it provides upfront approval of taxpayer operations (e.g., determination letter process, voluntary compliance programs). To measure its success, TE/GE uses a composite of measures, including, for a given fiscal year, the total compliance contacts; the number of examinations cases that are closed; the number of determination cases that are closed; employee satisfaction; and the number of customers reached. TE/GE also monitors “quality” measures (quality, timeliness, and customer satisfaction) associated with its major programs such as Examinations and Determinations.

The four basic key customer needs within EP provide the following:

- EP R&A provides three different types of services: voluntary compliance through its correction programs—EPCRS; issuance of determination letters which provide advance assurance that the retirement plan in question satisfies the qualification requirements of applicable law; and technical guidance, regulations, revenue rulings, revenue procedures, notices, and announcements that explain how the law is interpreted by the IRS. In producing its technical guidance (which consists of regulations, revenue procedures, revenue rulings, notices, and announcements), the IRS works extensively with the Office of Chief Counsel and the U.S. Department of the Treasury. EPCRS was developed in conjunction with plan sponsors and plan practitioners to permit self-correction in certain instances. Its focus is on correction rather than sanctions and the volume of its annual receipts reflects its popularity.
- EP CE&O provides outreach efforts directed to plan sponsors, practitioners, service providers, and participants/beneficiaries to help them better understand how their retirement plans should work. Through its phone forums and workshops, the Service can provide an informal check for its customers. Its plain language publications and the tools provided on its Retirement Plan Navigator website provide “soft” guidance for its customers. EP’s Employee Plans News reaches over 156,000 subscribers, and Retirement News for Employers reaches over 148,000 subscribers.
- EP Examinations provides a prominent enforcement presence to support voluntary compliance in plan operations by reviewing the operation of retirement plans for consistency with plan terms and pension law. Examples of EP Exam’ critical areas of interest include: terminating abusive transactions or schemes involving retirement plans; examining plans with the highest risk for noncompliance; monitoring plan funding together with the DOL and the Pension Benefit Guaranty Corporation; and increasing compliance contacts through unique initiatives and through the EPCU.
- EP customer account services.

As of the date of this Report, the Director of EP is Robert S. Choi, who oversees EP with three managing directors: Mark O'Donnell, director of EP CE&O; Andrew E. Zuckerman, director of EP R&A; and Monika A. Templeman, director of EP Exam.<sup>63</sup> Within EP R&A, there are six managers.<sup>64</sup> Within EP Exam, there are three special managers<sup>65</sup> and five Area Managers of EP Exam.<sup>66</sup> Within CE&O, there is a manager and a staff assistant manager.<sup>67</sup>

The estimated level of assets in retirement plans that were covered within EP's jurisdiction totaled \$17.9 trillion in the fourth quarter of 2011—comprising \$7.6 trillion in private plans; \$1.5 trillion in federal governmental plans and \$3.0 trillion in state and local plans; \$4.9 trillion in IRA; and close to \$748 billion in 403(b) plans.<sup>68</sup>

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<sup>63</sup> See IRS Publication 3636 (Rev. 10-2011).

<sup>64</sup> The six managers include: Vickie Surguy, Manager of EP Determination; William Hulteng, Manager of EP Technical; Janet Mak, Manager of EP Voluntary compliance; Daniel Jones, Manager of EP Determinations Quality Assurance; Joyce Kahn, Manager of EP Technical Guidance and Quality Assurance; and Joleah White, Manager of EP Planning, Analysis and Reporting.

<sup>65</sup> Betty McClernan is Area Manager of Exam Programs and Review (EP&R), who oversees the three EPCU groups, Classification, Mandatory Review, Special Review and the EP Exam Special Support and Processing Unit (EP Exam's Closing Unit). William "Buck" Kerr is the Manager of EP Planning and Programs (EPP). Jeff Milling is the Manager of the EP Field Actuaries, who supports both EP Examinations and EP Determinations.

<sup>66</sup> Presently the five Area Managers of EP Exam include: Janice Gore, Great Lakes Area Manager; Michael Sanders, Mid-Atlantic Area Manager; Thomas Petit, Gulf Coast Area Manager; William Dolce, Northeast Area Manager; and Colleen Patton, Pacific Coast Area Manager.

<sup>67</sup> The staff assistant within CE&O is John C. Schmidt. There are five Area Analysts who coordinate speaking and exhibiting event and eight others who write content for the website and the two newsletters, maintain internal websites, and produce videos and publications.

<sup>68</sup> See the report from the Investment Company Institute at [http://www.ici.org/research/retirement/retirement/ret\\_11\\_q4](http://www.ici.org/research/retirement/retirement/ret_11_q4).

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## Appendix C: Opening Letter – Sample IDR—Notice of Examination



**DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE**

TE/GE EMPLOYEE PLANS  
[STREET ADDRESS]  
[CITY, STATE] [ZIP]

[DATE]

[PLAN ADMINISTRATOR CONTACT FROM FORM 5500]  
[TITLE]  
[ENTITY]  
[STREET ADDRESS #1]  
[STREET ADDRESS #2]  
[CITY, STATE] [ZIP]

Re: Examination of [NAME OF PLAN], [PLAN NUMBER] – [PLAN YEAR ENDING [DATE],  
20[XX]

Dear [CONTACT]:

This letter is formal notice that the plan listed above has been selected for examination by the examinations function of the Employee Plans office of the Tax Exempt and Governmental Entities division of the Internal Revenue Service. More information about Employee Plans can be found at [www.irs.gov/ep](http://www.irs.gov/ep).

The examination process is intended to ensure that the plan is established and operated in a manner consistent with applicable Internal Revenue Code requirements and is not intended to generate revenue for the Internal Revenue Service (although if issues are identified during the examination process, penalties and interest may be assessed). Because many plans and plan sponsors have not experienced an Employee Plans examination previously, we provide the following summary information to help you prepare for the examination process:

- *Assigned Employee Plans Specialist and Contact Information.* The Employee Plans Specialist assigned to the examination is [NAME]. The Employee Plans Specialist may be reached by telephone at [PHONE], by facsimile at [FAX], and at the mailing address at the top of this letter, with all correspondence addressed to the Employee Plans Specialist's attention. The Employee Plans Specialist will initially be your main point of contact, although other Employee Plans personnel may be involved with the examination.
- *Scope, Duration, and Focus of Examination.* The scope, duration, and focus of the examination varies from examination to examination. Where few or no potential issues are found on initial review, an examination can be very short. However, when issues do come to light, especially when not affirmatively disclosed during initial conversations, the scope, duration and focus of an examination can grow. The focus of the examination can be described as follows:
  - *Initial Focus of Examination.* This examination will initially focus on the "internal controls" used to manage and govern the plan. "Internal controls" means the processes, procedures, and staffing behind these processes and procedures that are adopted and applied to ensure that the plan is maintained consistent with its plan document. By adopting an internal controls focus for this examination, the Internal Revenue Service is focused on the overall operational health of the plan rather than looking for a small inadvertent error. Internal controls processes and procedures can include activities and documentation prepared and maintained by you and/or by a service provider (such as a

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record keeper or third party administrator). Examples of internal controls questions can be found at <http://www.irs.gov/retirement/article/0,id=206492,00.html>.

- *Long-Term Focus of Examination.* After the completion of the initial study and evaluation of the plan's internal controls, a determination will be made as to the specific plans maintained by the employer (which includes all entities under common control with the employer listed above) and issues to be examined. In addition, after the completion of this study a decision may be made to limit our examination to the return and year mentioned above or to expand our examination to include additional qualified plans maintained by the employer and additional plan years for such plans.

Please note the initial action items for your review:

- *Initial Documents Requested.* Pursuant to Internal Revenue Service processes, you will receive one or more "Information Document Requests" (commonly called "IDRs") on Form 4564 throughout the examination process. The first two of these IDRs is enclosed with this letter.
  - *Key Plan Contacts IDR – IDR Response Due Prior to Initial Telephone Conference.* The first IDR enclosed with this letter focuses on understanding who plays what roles with respect to the plan. Please note, a response deadline is listed on this first IDR.
  - *Core Plan Documents IDR – IDR Response Due After Initial Telephone Conference.* The second IDR enclosed with this letter focuses on gathering relevant plan documents to facilitate the Employee Plans Specialist's review. This response deadline for this IDR is 21 days after the date of the initial telephone conference although you may respond to the IDR prior to the phone conference.

Please note that an IDR deadline may be extended at the discretion of the Employee Plans Specialist listed above. To request an extension, please write or send a facsimile to the Employee Plans Specialist that explains the reason that an extension is requested and the date (no longer than three weeks after the original response date) by which a response is requested. The Employee Plans Specialist will respond by phone or in writing (via mail or facsimile) regarding your request. Please note, requesting an extension will not in any way affect Employee Plans' approach to the examination.

- *Initial Telephone Conference.* Once you have provided the response to the Key Plan Contact IDR, the Employee Plans Specialist will be contacting you to schedule an initial telephone conference to discuss the examination process with you. Prior to this time, you may also contact the Employee Plans Specialist with respect to any questions you may have about the Key Plan Contact IDR or the Core Plan Documents IDR.
- *Subsequent Document Requests.* After the initial document request and your initial telephone conference with the Employee Plans Specialist, you can expect to receive additional IDRs.
- *Impact of Being Under Examination.* At this time, the plan is considered "under examination" for purposes of the Employee Plans Compliance Resolution System (EPCRS), for purposes of the Employee Plans determination letter program, and for other Internal Revenue Service filing purposes. A copy of EPCRS can be found at <http://www.irs.gov/pub/irs-drop/rp-08-50.pdf> and information about the Employee Plans determination letter program can be found at <http://www.irs.gov/retirement/article/0,id=96907,00.html>. What this means is that you may be limited in your ability to use EPCRS to correct certain plan document and operational failures, that you will need to disclose this pending examination in connection with a Employee Plans determination letter application, and that disclosure may be required in certain other situations (such as when requesting a private letter ruling relating to the plan).

Additional materials explaining the examinations process (including your rights throughout the examination process) are enclosed with this letter and can also be found at <http://www.irs.gov/pub/irs-pdf/p1ep.pdf>.

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**Employee Plans:  
Analysis and Recommendations Regarding the Scope of the EP Examination Process**

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Thank you for your assistance. I look forward to working with you in a collaborative manner. As noted above, I can be reached by phone at [PHONE], by facsimile at [FAX], or and at the mailing address at the top of this letter, with all correspondence addressed to my attention.

Sincerely,

Employee Plans Specialist  
Employee ID No. xxxxxxxx

Enclosure:  
Publication 1-EP  
Form 4564: Information Document Request (Subject XXX: Key Plan Contacts for Initial Examination Conference Call)  
Form 4564: Information Document Request (Subject XXX: Core Plan Documents)

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## Appendix D: Sample IDR – Key Plan Contacts For Initial Exam Conference Call

<b>Form 4564</b>	Department of the Treasury Internal Revenue Service Information Document Request	Request Number EP-XXX
To: [CONTACT INFORMATION FROM COVER LETTER]	Subject: Key Plan Contacts for Initial Examination Conference Call	
	Submitted to:	
	Dates of Previous Requests: None	

**Description of Documents Requested:**

**IDR Topic:     Key Plan Contacts**

**Deadline Information:**

The information requested in this request is needed on or before [DATE]. Additional information and/or an extension of the response deadline may be available by contacting the Employee Plans Specialist whose contact information is provided below.

Once this information is received, the Employee Plans Specialist will contact you to schedule the initial telephone conference for this examination.

**Information Requested:**

To facilitate the examination of the Plan, please provide the following information. The information may be provided in a separate letter or attachment or by completing the chart below. An electronic copy of this chart that can be completed electronically can be found at [INSERT WEB ADDRESS].

<b>Key Parties</b>		
Current Legal Name and EIN of Plan Sponsor:	Name:	EIN:
Current Legal Names of Entities in the Plan Sponsor's Controlled Group Participating in the Plan:	Names:	EINs:
Name, Address, and Phone Number of Current Plan Administrator		

Information	[DATE]	At Next Appointment	Mail In	
Title of Requestor				Date: [DATE]
Employee ID:				
FROM	Employee Plans Specialist Office Location:			
Phone:				
Fax:				

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Workpaper #: [TBD]

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**Employee Plans:  
Analysis and Recommendations Regarding the Scope of the EP Examination Process**

<b>Form 4564</b>	<b>Department of the Treasury Internal Revenue Service Information Document Request</b>	<b>Request Number EP-XXX</b>
<b>To:</b> [CONTACT INFORMATION FROM COVER LETTER]		<b>Subject:</b> Key Plan Contacts for Initial Examination Conference Call
		<b>Submitted to:</b>
		<b>Dates of Previous Requests:</b> None

**Description of Documents Requested:**

Name, Address, and Phone Number of Human Resources Personnel With Day-to-Day Plan Management Responsibilities	
Name, Address, and Phone Number of Lead Payroll Staff in Charge of Overseeing Payroll Involving Contributions to the Plan	
Name, Address, and Phone Number of External Payroll Provider (if any)	
Name, Address, and Phone Number of Recordkeeper (whether internal or external)	
Name, Address, and Phone Number of Third Party Administrator (whether internal or external)	
Name, Address, and Phone Number of Plan Trustee(s), Custodial Account Provider(s), and/or Annuity Provider(s) (whether internal or external)	
Name, Address, and Phone Number of Plan Consultant (if any)	

<b>Information</b>	<b>[DATE]</b>	<b>At Next Appointment</b>	<b>Mail In</b>
<b>FROM</b>	<b>Title of Requestor</b>	<b>Employee ID:</b>	<b>Date:</b> [DATE]
	<b>Employee Plans Specialist</b>		
	<b>Office Location:</b>	<b>Phone:</b>	
		<b>Fax:</b>	

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Workpaper #: [TBD]

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## Appendix E: Sample IDR – Core Plan Documents

<b>Form 4564</b>	<b>Department of the Treasury</b> <b>Internal Revenue Service</b> <b>Information Document Request</b>	<b>Request Number</b> <b>EP-XXX</b>
<b>To: [CONTACT INFORMATION FROM COVER LETTER]</b>	<b>Subject:</b> Core Plan Documents	
	<b>Submitted to:</b>	
	<b>Dates of Previous Requests:</b> None	

**Description of Documents Requested:**

**IDR Topic:**     **Core Plan Documents**

**Deadline Information:**

The information requested in this request is needed on or before 21 days after your initial telephone conference with the Employee Plans Specialist. Additional information and/or an extension of the response deadline may be available by contacting the Employee Plans Specialist whose contact information is provided below.

**Information Requested:**

To facilitate the examination of the Plan, please provide the following information. The information may be provided in a separate letter or attachment or by completing the chart below. An electronic copy of this chart that can be completed electronically can be found at [INSERT WEB ADDRESS]. You may provide this information prior to the initial examination conference call but will, in all cases, have until 21 days after the date of the initial examination conference call to provide the requested information.

Core Plan Document Requested	Enclosed With Response (Yes or No)	If Not Provided, Explanation of Why Document Not Provided (Such as Not Available/Not Applicable, and Why)
Current Plan Document  (For Prototype/Volume Submitter Plans, a Current Adoption Agreement and Base Plan Document Should Be Included)  (For Individually Designed Plans, the Current Restated Plan Document and Any Amendments After the Restatement Should Be Adopted. Working Copies Should Not Be Submitted)		

<b>Information</b>	<b>[DATE]</b>	<b>At Next Appointment</b>	<b>Mail In</b>	
<b>Title of Requestor</b>  <b>Employee ID:</b>			<b>Date:</b> <b>[DATE]</b>	
<b>FROM</b>	<b>Employee Plans Specialist</b> <b>Office Location:</b>  <b>Phone:</b> <b>Fax:</b>			

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Workpaper #: [TBD]

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**Employee Plans:  
Analysis and Recommendations Regarding the Scope of the EP Examination Process**

<b>Form 4564</b>	<b>Department of the Treasury Internal Revenue Service Information Document Request</b>	<b>Request Number EP-XXX</b>
<b>To:</b> [CONTACT INFORMATION FROM COVER LETTER]		<b>Subject:</b> Core Plan Documents
		<b>Submitted to:</b>
		<b>Dates of Previous Requests:</b> None

**Description of Documents Requested:**

<p>Historical Plan Documents</p> <p>(For Prototype/Volume Submitter Plans, All Interim Amendments and Documents (Either Signed By Your Provider or By The Plan Sponsor) Adopted Since "EGTRRA" (Generally Since 2001), or, if Later, the Most Recent Favorable Determination (Not Opinion) Letter For the Plan)</p> <p>(For Individually Designed Plans, All Amendments Adopted Since The Plan's Most Recent Favorable Determination Letter)</p> <p>For more information on various amendment requirement, please see <a href="http://www.irs.gov/retirement/article/0,,id=218235,00.html">http://www.irs.gov/retirement/article/0,,id=218235,00.html</a></p>		
Current Trust Document(s), Custodial Account Agreement(s), and/or Annuity Contract(s), Including Any Amendments to the Most Recent Restated Documents		
Most Recent Favorable Determination Letter (Individually Designed and Some Prototype/Volume Submitter Plans)		
Most Recent Favorable Opinion Letter (Prototype/Volume Submitter Plans Only)		
Form 5500 For Plan Year Ending [DATE], 20[XX]		
This Form 5500 may be obtained from <a href="http://www.dol.gov/ebsa">http://www.dol.gov/ebsa</a>		
Plan Service Manuals (Administrative Manuals, Service Documents, Process Charts, Etc.)		
Legally Required Notices (Safe Harbor Notices, Etc.)		
Results on ADP, ACP, and Coverage Testing (May Be Provided by Service Providers)		

<b>Information</b>	<b>[DATE]</b>	<b>At Next Appointment</b>	<b>Mail In</b>
<b>Title of Requestor</b>			<b>Date:</b>
Employee ID:			<b>[DATE]</b>
<b>FROM</b>	Employee Plans Specialist		
	Office Location:		
	Phone:		
	Fax:		

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## Appendix F: Sample IDR – Plan Document Update Process

<b>Form 4564</b>	<b>Department of the Treasury Internal Revenue Service Information Document Request</b>	<b>Request Number EP-XXX</b>
<b>To:</b> [CONTACT INFORMATION FROM COVER LETTER]	<b>Subject:</b> Plan Document Update Process	
	<b>Submitted to:</b>	
	<b>Dates of Previous Requests:</b> None	

**Description of Documents Requested:**

**IDR Topic:** Internal Controls – Plan Document Update Process – IDR #1

**Deadline Information:**

The information requested in this request is needed on or before 21 days after the date of this letter. Additional information and/or an extension of the response deadline may be available by contacting the Employee Plans Specialist whose contact information is provided below.

**Information Requested:**

To facilitate the examination of the Plan, please provide the following information. The information may be provided in a separate letter or attachment or by completing the chart below. An electronic copy of this chart that can be completed electronically can be found at [INSERT WEB ADDRESS].

More information about processes used to ensure that plan documents are timely and regularly updated can be found at <http://www.irs.gov/retirement/article/0,,id=253905,00.html>.

Plan Document Update Process Questions	
Please identify who is responsible for signing and dating amendments to the plan?	
Was this person identified as a Key Plan Contact in response to this examination's initial Key Plan Contacts IDR (Yes or No). If the answer is "No", please provide the name, address and phone number of this person.	
Do you have an annual review process to ensure that any potentially required plan amendments are identified? If so, please explain this process.	
Do you verify your plan documents against your summary plan description to ensure that they are consistent?	
How, when, and by whom are potentially required plan amendments identified?	
Who is responsible for drafting your plan amendments?	

<b>Information:</b>	<b>[DATE]</b>	<b>At Next Appointment</b>	<b>Mail In</b>
<b>FROM:</b>	<b>Title of Requestor</b>	<b>Employee ID:</b>	<b>Date:</b> [DATE]
	<b>Employee Plans Specialist</b>		
	<b>Office Location:</b>	<b>Phone:</b>	
		<b>Fax:</b>	

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Workpaper #: [TBD]

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NOT APPROVED FOR IRS USAGE

**Employee Plans:  
Analysis and Recommendations Regarding the Scope of the EP Examination Process**

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<b>Form 4564</b>	<b>Department of the Treasury Internal Revenue Service Information Document Request</b>	<b>Request Number EP-XXX</b>
<b>To: [CONTACT INFORMATION FROM COVER LETTER]</b>	<b>Subject: Plan Document Update Process</b>	
	<b>Submitted to:</b>	
	<b>Dates of Previous Requests: None</b>	

**Description of Documents Requested:**

Do you provide copies of signed and dated amendments to all of the Key Plan Contacts identified in the this examination's initial Key Plan Contacts IDR (Yes or No). If yes, what process is used to ensure that copies are distributed? If no, who does receive signed and dated copies of amendments and by what process?

Have you previously identified failure(s) to timely amend the plan document? If so, how did you correct each of these failures. Please provide documentation of any correction.

<b>Information</b>	<b>[DATE]</b>	<b>At Next Appointment</b>	<b>Mail In</b>
<b>Title of Requestor</b>			<b>Date:</b>
<b>Employee ID:</b>			<b>[DATE]</b>
<b>FROM</b>	<b>Employee Plans Specialist</b>		
<b>Office Location:</b>			
<b>Phone:</b>			
<b>Fax:</b>			
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<b>Workpaper #: [TBD]</b>			

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## **Appendix G: Persons Who Provided Input and/or Were Consulted**

### **1. Government (in alphabetical order)**

- George Brim, EPTA Manager, Mid-Atlantic
- Robert S. Choi, Director, EP
- Craig Chomyok, EPCU Manager
- William Dolce, Northeast Area Manager, EP Examinations
- Richard A. Ervi, Senior Tax Analyst, EP Examinations
- Jackson Joe, Senior EPTA Agent
- Gail Jones, Tax Analyst, EPCU Group 7698 Waukesha, WI
- Joyce Kahn, Manager, EP Technical Guidance & Quality Assurance, EP Rulings & Agreements
- William (Buck) Kerr, Manager, EP Planning and Programs (EPP)
- Lou Leslie, Manager, EP Program Management Staff
- Jonathan Limes, Internal Revenue Agent, EP Specialist
- Betty McClernan, Manager, EP Examinations, Exam Programs and Review (EP&R)
- Rhonda Migdail, Manager, Group 2, EP Technical Guidance & Quality Assurance
- Craig Moore, EPTA Manager, Pacific Coast
- Mark O'Donnell, Acting Director, EP Rulings & Agreements
- Colleen Patton, Pacific Coast Area Manager, EP Examinations,
- Jacquelyn Petkovich, EPTA Group Manager, Pacific Coast
- Janet Poremski, Senior EPTA Agent
- Michael Sanders, Mid-Atlantic Area Manager, EP Examinations,
- John Schmidt, Acting Director, EP CE&O

- Maureen Szostak, Large Business & International, on assignment to EP Examinations
- Monika Templeman, Director, EP Examinations
- Mikio Thomas, Analyst, EP Examinations
- Sheila Tidline, Senior EPTA Agent
- Andrew E. Zuckerman, Director, EP Rulings & Agreements

## **2. Private**

- Wayne Kamenitz, Executive Director, Human Capital Performance & Reward
- Frances Marbury, Executive Director, Human Resource Risk Advisory Services, Ernst & Young

**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Exempt Organizations:  
Form 1023 – Updating It for the Future**

Karen A. Gries, Co-Leader  
Celia Roady, Co-Leader  
Eric B. Carriker  
J. Daniel Gary  
James P. Joseph  
Marty Martin

**June 6, 2012**

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## **I. Executive Summary**

Each year more than 55,000 organizations file Internal Revenue Service (IRS) 1023 forms to seek recognition of exemption under Section 501(c)(3) of the Internal Revenue Code (Code or IRC). Form 1023 is a “one size fits all” form that is used by all filers. These filers include everything from very small, all-volunteer organizations, such as local parent-teacher organizations with annual revenues of less than \$10,000, to very large and complex organizations, such as academic medical centers with annual revenues of more than \$100 million. Unlike Form 990, there is no “EZ” version of Form 1023.

For more than 50 years, Form 1023 has been the application for organizations seeking recognition of exemption under Section 501(c)(3). The form has evolved significantly through the years. Early versions were just a couple of pages long with no schedules included. Revised in 2006, the current version is 12 pages long, with 14 pages of schedules that apply to certain types of organizations. This revision made the form significantly more complex, but it does not reflect the legislative changes made by the Pension Protection Act of 2006 (PPA). The 2006 version also predated the IRS redesign of Form 990 in 2008, creating some inconsistencies in definitions between the two forms.

This project, undertaken at the suggestion of the IRS, grew out of the ACT’s belief that the time is right to review and update Form 1023. An important part of this report addresses how the current form could be updated to meet the objectives of the stakeholders for which it has significance. In addition to the filers and the IRS, these stakeholders include state charity regulators, donors, and the general public, all of which rely on Form 1023 for information about Section 501(c)(3) organizations, and can play an important role in helping to leverage IRS resources by identifying potentially noncompliant organizations.

In deciding on this project, the ACT was mindful that a prior ACT report in 2003 also addressed the IRS exemption process. That report recommended, among other things, that the IRS develop a fully e-fileable Form 1023. We strongly reiterate that recommendation and urge the IRS to chart a course for e-filing Form 1023—Form e-1023. In our view, this will be the best way for the IRS to achieve a higher level of efficiency in the handling and review of 1023 forms. It will help eliminate filing errors, provide an opportunity to include greater educational content in the software, facilitate the eventual availability of an electronic database of 1023 forms for the IRS and on websites such as GuideStar, and further other important public and governmental objectives. Any update of Form 1023 should be undertaken with a view to implementing electronic filing as rapidly as possible.

We recognize that our recommendations will require significant resources in terms of budget and personnel; and we are mindful of the many competing demands that have to be addressed within the IRS. Nevertheless, there is no question that implementing the recommendations in this report will strengthen the ability of TE/GE to regulate Section 501(c)(3) organizations.

The Form 1023 application process is the one and only contact that many organizations have with the IRS. Providing an updated form with enhanced educational content that can be prepared and filed electronically will be of enormous value to the IRS and the organizations it regulates, as well as the other stakeholders and the sector as a whole.

Our specific recommendations are as follows:

1. the IRS should expedite the internal processes and commit the necessary resources (human, financial, and technical) to transform Form 1023 to an interactive Web-based Form e-1023 that can be filed electronically and stored, transmitted, and disseminated in an electronic database format. This information will serve as the electronic gateway for IRS knowledge about tax-exempt organizations;
2. the IRS should redesign Form 1023 with four primary objectives: to make the form (i) **effective** at identifying whether organizations meet the requirements for recognition of exemption; (ii) **consistent** with the structures and definitions of Form 990; (iii) **simple** by using a short core form with supplemental schedules that will ease the filing burden on small and/or less complex organizations; and (iv) **educational** by organizing questions based on substantive exemption requirements and including explanatory information;
3. the IRS should develop more educational tools about Form 1023 including tips for filing Form 1023, and more information about the substantive requirements for recognition of exemption. The development of these tools, coupled with the redesign of Form 1023, should obviate the need for a separate “Form 1023-EZ” for small organizations. The ACT does not recommend the development of such a form;
4. the IRS should coordinate with the Department of the Treasury and the Office of Chief Counsel on the issuance of precedential guidance about tax-compliant alternatives to the creation of new Section 501(c)(3) organizations, such as fiscal sponsorships and donor-advised funds;
5. the IRS should carefully examine recurrent complaints about the Form 1023 filing and review process and take appropriate and expeditious steps to improve the effectiveness, efficiency, and timeliness of that process; and
6. the IRS should expand its use of the Review of Operations (ROO) program (to follow up on Section 501(c)(3) organizations whose 1023 forms indicate potential future compliance issues), and should consult with state charity regulators regarding indicia that may warrant such follow-up.

## **II. Statement of Problem and Project Objectives**

### **A. Problem**

As its name implies, Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, is the form that organizations file to be recognized as tax exempt under Section 501(c)(3). With few exceptions, an organization must file Form 1023 if it wishes to be recognized as tax exempt under Section 501(c)(3).<sup>1</sup> And all of these organizations must file the same form, regardless of their size or complexity.

Form 1023 has been revised a number of times over the years, with the last revision in June 2006, prior to the PPA and the Form 990 redesign. Because the form does not reflect some relevant PPA changes and other recent regulatory developments (e.g., the elimination of the advance ruling process), it is out of date and needs to be updated. Now is a good opportunity to take a holistic look at Form 1023 to see whether the form is meeting its objectives in a balanced way that takes into account the needs and burdens of all stakeholders, including the IRS, organizations seeking recognition of exemption, state charity regulators, donors, and the public.

### **B. Project Objectives**

Form 1023 is an extremely important document to the IRS in carrying out its responsibilities to administer the tax laws. In addition to serving as the tool used by the IRS to determine whether organizations meet the requirements to obtain recognition of exemption under Section 501(c)(3), it is often the one and only point of “hands-on” contact the IRS has with these organizations. The form should be constructed not only to enable the IRS to screen out organizations that do not qualify for exemption, but also to educate qualifying organizations about the rules applicable to Section 501(c)(3) organizations.

In the ACT’s view, the vast majority of Form 1023 filers are likely relatively small, all-volunteer organizations that prepare the forms themselves or with the assistance of pro bono lawyers or accountants who have limited experience with the rules under Section 501(c)(3). These organizations must run the gauntlet of questions that often have little relevance to them, and they must do so without sufficient guidance as to how the questions relate to the requirements for obtaining and maintaining tax exemption.

At the same time, some Form 1023 filers are among the most complex Section 501(c)(3) organizations. They are well represented by lawyers and accountants who specialize in the law of tax-exempt organizations. But even these organizations find themselves answering

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<sup>1</sup> Churches, certain other religious organizations, and organizations (other than private foundations) with annual gross receipts not exceeding \$5,000 are not required to file Form 1023 to be treated as exempt under Section 501(c)(3). I.R.C. § 508(c)(1).

questions that appear to be confusing and repetitive, and they may have little sense as to how these questions relate to the substantive exemption requirements.

In summary, the project objectives are to:

- reexamine Form 1023;
- identify the purposes the form should serve;
- consider possible changes to improve the ability of the form to serve the identified purposes; and
- make recommendations as to how the form should be redesigned to enhance its utility to the relevant stakeholders.

### **III. Process**

The ACT reviewed Form 1023 and its instructions, as well as predecessor versions of the form. The IRS provided historical information about the form, statistical data regarding the number of 1023 forms filed annually, and the aggregate profile of Form 1023 filers. The IRS also provided information on its unsuccessful efforts to develop Cyber-Assistant, a computer-based tool intended to guide users through the Form 1023 preparation process.

The ACT conducted a series of interviews with IRS officials and staff. These interviews focused on issues, challenges, and concerns associated with the Form 1023 filing process including common mistakes made by filing organizations, and challenges associated with the feasibility of transitioning to an electronic Form 1023 filing process.

The ACT interviewed the National Taxpayer Advocate and a senior member of her staff. The National Taxpayer Advocate discussed concerns with respect to Form 1023 -- with particular focus on the challenges faced by small organizations using the form. In addition, the ACT reviewed relevant portions of the National Taxpayer Advocate's Annual Report to Congress for 2011 including her recommendation that the IRS develop a Form 1023-EZ to simplify the filing burden for smaller organizations.<sup>2</sup>

The ACT obtained information from members of the National Association of State Charity Officials (NASCO).<sup>3</sup> A member of the ACT consulted with interested participants<sup>4</sup> from NASCO about general issues concerning Form 1023 including: what types of organizations received Section 501(c)(3) status that should not have earned such status; what changes should be made to the form or to the IRS review process to prevent improper granting of Section 501(c)(3) status; how the form could be better used by the public and regulators to promote transparency and accountability; whether there should be tools such as e-filing available for Form 1023 filers; and whether there should be federal legislation to allow state input or participation in the Form 1023 review process as well as IRS post-determination review of Section 501(c)(3) organizations.

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<sup>2</sup> National Taxpayer Advocate 2011 Annual Report to Congress, vol. 1, at 450 and 563, *available at* <http://www.irs.gov/advocate/article/0,,id=252216,00.html>.

<sup>3</sup> NASCO is made up of state charity regulators, including Attorneys General, Secretaries of State and Commissioners of Consumer Affairs, whose responsibilities include oversight of tax-exempt entities. That oversight includes administering state registration and reporting requirements, and ensuring that charitable assets are appropriately managed, charitable fiduciaries fulfill their duties of loyalty and care, donor intent is fulfilled, and fraudulent fundraising is remedied. *See* comments, Model Protection of Charitable Assets Act (2011), [http://www.law.upenn.edu/bl/archives/ulc/ocaa/MPOCAA\\_Final\\_2011.htm](http://www.law.upenn.edu/bl/archives/ulc/ocaa/MPOCAA_Final_2011.htm).

<sup>4</sup> The ACT gratefully acknowledges the state charity regulators who provided feedback for this project. They included Bob Carlson (MO Attorney General's Office), Elizabeth Grant (OR Attorney General's Office), Therese Harris (IL Attorney General's Office), Belinda Johns (CA Attorney General's Office), Terry Knowles (NH Attorney General's Office), Karin Kunstler Goldman (NY Attorney General's Office), Joseph Kylman (MI Attorney General's Office), Hugh Jones (HI Attorney General's Office), Dena Markowitz (PA Secretary of State's office), Mark Pacella (PA Attorney General's Office), and Ed Shevenock (PA Secretary of State's Office).

In addition, the ACT interviewed 19 practitioners, most of whom have had significant experience with Form 1023. These practitioners represent a wide range of large and small charitable organizations. The group included a law professor who supervises a community development law clinic for law students who file 1023 forms on behalf of new community development organizations. These practitioners answered a series of questions about the current version of Form 1023 and offered views about potential changes to the form.<sup>5</sup>

The ACT interviewed individuals familiar with the design and implementation of databases and the history related to the Urban Institute and GuideStar's use of Form 990.

Finally, the ACT obtained input from members of the American Institute of Certified Public Accountants (AICPA) with respect to their experience filing 1023 forms on behalf of a variety of organizations. AICPA members raised issues and concerns with respect to Form 1023, and also offered suggestions for consideration in the redesign of the form.

### **A. History of the Form 1023**

The Revenue Act of 1950 increased the scrutiny of exempt organizations in the United States, with formal procedures for applying for recognition of tax-exempt status also being introduced around that time. Form 1023 (revised March 1951) originally was a four-page document that requested information similar to some of what is requested on today's form – details about the organization's charitable purpose and activities, lobbying, sources of revenue and transactions with the creator of the organization, contributors to the organization, and certain related individuals. In addition, like today's form, the 1951 version required a statement of revenue and balance sheet, along with organizing documents, bylaws, and copies of leases.

Over the years, the form expanded both the scope and depth of the questions. Changes made to the Code also required additional disclosures on the form. Today's Form 1023 is a 12-page form with 14 pages of schedules that apply to certain types of organizations, and is accompanied by 38 pages of instructions. As with earlier versions of the form, organizations are required to provide organizational documents, details on activities and operations, financial data, and foundation classification. In addition, the form now requires organizations to answer detailed questions regarding governance practices, compensation practices, conflicts of interest, and transactions with insiders.

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<sup>5</sup> The ACT gratefully acknowledges the practitioners who provided feedback for this project. They included Betsy Buchalter Adler (Adler and Colvin), Victoria Bjorklund (Simpson Thacher), Jean Carter (Hunton and Williams), Gregory Colvin (Adler and Colvin), Michael Durham (Caplin and Drysdale), Julie Floch (Eisner Amper), J. William Gray (Hunton and Williams), Diara Holmes (Caplin and Drysdale), Thomas Kelly (University of North Carolina School of Law), Andras Kosaras (Arnold & Porter LLP), Kevin Lavin (Arnold & Porter LLP), Suzanne R. McDowell (Steptoe and Johnson), Marcus S. Owens (Caplin and Drysdale), Jennifer Reynoso (Simpson Thacher), David Shevlin (Simpson Thacher), Jack Siegel (Charity Governance), Steven Simpson (Wyrick Robbins), Carolyn O. (Morey) Ward (Ropes & Gray LLP), and Bridget M. Weiss (Arnold & Porter LLP).

## B. Number and Profile of Form 1023 Filers

IRS records indicate that in 2011, there were approximately 1.5 million tax-exempt organizations, and, of these, just over one million were exempt under Section 501(c)(3).<sup>6</sup> The 990 forms filed by existing Section 501(c)(3) organizations provide some information about the profile of organizations that file 1023 forms.<sup>7</sup> These organizations are of all sizes—from the very small to the very large. They engage in activities spanning the entire spectrum of human experience including the arts, education, human services, medicine, science, and religion. However, there is one thing they have in common. They all file the same Form 1023.

In 2011, the IRS processed more than 55,000 1023 forms: nearly 50,000 were approved and approximately 200 were denied, and no determination was made on about 5,400.<sup>8</sup> The IRS provides several reasons why it does not make determinations on certain applications including “applications withdrawn by the organization; applications that did not provide the required information; incomplete applications; IRS refusals to rule on applications; applications forwarded to other than the Washington, DC, office; IRS correction disposals; and others.”<sup>9</sup>

While there is no granular data about these “no determination” cases, the sheer number of them is difficult to ignore. No doubt, there are many organizations that do not submit complete applications, or that refuse to respond to IRS requests for additional information. We suspect that there may also be some small organizations that simply gave up because they were overwhelmed by the application process. Also, we have no basis for assessing whether there should be concern about the number of cases where the IRS refuses to rule on an application for policy or other reasons unrelated to the completeness of the application.

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<sup>6</sup> 2011 IRS Data Book, Table 25, available at <http://www.irs.gov/taxstats/article/0,,id=102174,00.html>. (Note that both the 1.5 million and 1.0 million figures cited above understate the true numbers because these figures do not include all churches and certain other types of religious organizations. IRS records are not complete for churches and these other types of religious organizations because they are not required to file the Forms 1023 or annual Forms 990.)

<sup>7</sup> See, e.g., Kennard T. Wing, Katie L. Roeger, and Thomas H. Pollak, *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering*, 2010, The Urban Institute, available at <http://www.urban.org/uploadedpdf/412209-nonprof-public-charities.pdf>. See also Rob Reich, Lacey Dorn, and Stefanie Sutton, *Anything Goes: Approval of Nonprofit Status by the IRS*, October 2009, Stanford University Center on Philanthropy and Civil Society (“PACS”), at 15, available at <http://www.stanford.edu/~sdsachs/AnythingGoesPACS1109.pdf> (classifying the Section 501(c)(3) organizations approved by the IRS in 2008 by their National Taxonomy of Exempt Entities (“NTEE”) Codes).

<sup>8</sup> 2011 IRS Data Book, Table 24. (Note that the actual Section 501(c)(3) numbers shown in Table 24 for total filings, approvals, denials, and no determinations are 55,319, 49,677, 205, and 5,437, respectively. We have chosen to use approximations to these actual numbers because the numbers in Table 24 include other “case closures” besides Forms 1023. As stated in Footnote 1 to Table 24, the table “[r]eflects all case closures for the Exempt Organizations Determinations function. These include not only initial applications for tax-exempt status, but also other determinations, such as public charity and private foundation status determinations, advance approval of scholarship grant procedures, and group determinations of tax-exempt status.” We assume, however, that the vast majority of these case closures do, in fact, relate to the Forms 1023; hence, we have approximated the actual numbers of the Forms 1023 in accordance with that assumption.

<sup>9</sup> *Id.* at note 3.



One thing that is clear from these Form 1023 statistics is the high approval rate.<sup>10</sup> Of the 55,000 cases that were processed in 2011, almost 50,000—some 90%—were approved.<sup>11</sup> This high approval rate may not be as surprising as it appears on first glance. It may just reflect the fact that applicants typically file 1023 forms when they are newly formed; and so there is typically nothing “bad” in the organizations’ (very short) history. Also, we assume that most applying organizations indicate on their 1023 forms that they intend to be compliant with all the applicable rules.

### **C. Current Form 1023 Filing Process**

The Form 1023 filing process begins when applicants download a PDF file containing a 12-page paper application form. An applicant completes the form; attaches its articles of incorporation and bylaws; explains its responses to the form’s questions; completes any required schedules; and includes a user payment fee. A typical application including the articles, bylaws and other attachments, may run 40-50 pages or more in length. We estimate that approximately 25% of applications are prepared by professionals (i.e., lawyers and accountants).

This paper form is mailed to the Covington, Kentucky, mail processing center, which generates a form letter acknowledging receipt of the application within a few weeks. The application is logged and scanned into the Tax Exempt Determination System (TEDS), which produces an electronic file with limited search capability. IRS personnel enter some information by hand. While the application can be read on the TEDS computer screen, TEDS does not have the ability to integrate with other IRS electronic data systems.<sup>12</sup>

Applications are sent electronically via TEDS to the Cincinnati EO office for processing. All applications go through an initial screening process. Well over half of all Form 1023 applications are closed favorably within a relatively short period of time as a result of the initial screening or after some limited follow-up. For example, in 2011 60% of the applications were closed in less than 90 days, with only about 40% of applications requiring significant full development. In terms of processing time, this is a significant improvement from 2004, when only about one-third of the cases were closed without full development.

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<sup>10</sup> Reich, *supra* note 7 (studying the Form 1023 approval rate over time and performing a detailed analysis of the Section 501(c)(3) organizations approved by the IRS in 2008).

<sup>11</sup> If the “no determination” closings are excluded from the calculation, the approval rate is more than 99%, although many of the “no determination” cases are likely to involve organizations that withdrew their applications rather than face denial.

<sup>12</sup> The role and limitations of TEDS as an interim technology were noted in a 2003 ACT report that addressed the IRS determinations process. The 2003 ACT report stated that “while still not as advanced technologically as it should be, TEDS should improve the tracking of applications and expedite their release to the public until more advanced technology can be acquired and implemented.” The 2003 ACT report is discussed below in more detail. *See generally* Second Report of the Advisory Committee on Tax Exempt and Government Entities Public Meeting, May 21, 2003, *available at* [http://www.irs.gov/pub/irs-tege/tege\\_act\\_rpt2.pdf](http://www.irs.gov/pub/irs-tege/tege_act_rpt2.pdf).



Applications that are not closed as part of the initial screening (40% in 2011) are “graded” based on type of organization, complexity, and other factors. These applications are assigned for full development to determination specialists who, based on their expertise and experience, work on cases at particular grade levels. The availability of a specialist cleared for the appropriate grade level impacts the assignment and review process. In cases where the application raises issues for which there is no established published precedent or for which non-uniformity may exist, EO Determinations refers the application to EO Technical. In EO Technical, the applications are reviewed by tax law specialists, whose job is to interpret and provide guidance on the law and who work closely with IRS Chief Counsel attorneys on the issues.

As of March 2012, EO was assigning applications for review that were received in July 2011—some eight months earlier. The period of time between the filing of an application and the closing of the case can vary significantly. A case that is not closed as part of the initial screening almost surely takes six to eight months to complete, and may take considerably longer—as much as several years—if the case goes to the EO National Office for review.

Listed by the IRS in order by their frequency of occurrence, the current “Top Ten Reasons for Delays” are:

1. incorrect or no user fee;
2. failure to include articles of incorporation and amendments;
3. failure to include bylaws;
4. failure of the appropriate officer to sign the form and indicate his or her title;
5. failure to complete all required pages;
6. failure to complete all required schedules;
7. insufficient information demonstrating how the exempt purpose will be achieved;
8. failure to include the required information for principal officers and directors;
9. failure to include the ending month of the annual accounting period; and
10. insufficient financial data.<sup>13</sup>

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<sup>13</sup> See Internal Revenue Service, *Top Ten Reasons for Delays in Processing Exempt Organization Applications*, <http://www.irs.gov/charities/article/0,,id=96361.00.html> (last visited Mar. 30, 2012).

While all of these “Reasons for Delays” slow down the application process somewhat, it is important to note that most of them do not result in any significant delay, and are dealt with at the screening level, and resolved without the need to assign the application to a determination specialist for full development.

#### **D. IRS Quality Control Process**

Quality control and customer satisfaction are important aspects of the Form 1023 filing process. Implementing a strong quality control system helps ensure that applications are processed correctly under the law and consistently across the applicant pool. Monitoring customer satisfaction helps ensure that the customer experience meets reasonable expectations of service. We understand that the IRS implements a detailed quality control process with respect to applications for exemption as well as a process for regularly establishing customer satisfaction. While the IRS was not able to share the results with the ACT, these processes are designed to provide valid and reliable feedback that the IRS uses to access its processes and make enhancements when and if applicable.

#### **E. Review of Operations Process**

Another important part of the Form 1023 process is the ROO function, which is used both for routine monitoring and enforcement and to follow up on certain approved 1023 forms to confirm whether the organizations’ actual operations were as represented on the exemption applications. The ROO receives referrals of specific organizations for which there are concerns about aspects of their proposed operations but insufficient basis to deny recognition of exemption. As part of its internal quality control and monitoring and enforcement programs, the IRS also designates a random sample of the approved 1023 forms for referral to the ROO for follow-up review.

The ROO unit consists of a dedicated team of specialists who use publicly available information including the 990 forms, websites, and other public sources, to review whether an organization’s actual manner of operations is consistent with representations on its Form 1023. If it appears to the ROO unit, based on the publicly available information, that an organization is not operating in conformity with the representations made as part of its exemption application, it may refer the organization for audit.

#### **F. IRS Resources for Form 1023 Filers**

The IRS provides information at [www.irs.gov](http://www.irs.gov) to assist organizations applying for tax-exempt status. This includes StayExempt.org ([www.stayexempt.org](http://www.stayexempt.org)), which is a site designed for Section 501(c)(3) organizations. The site contains educational information for new and existing organizations. The following resources on StayExempt.org relate to the Form 1023 filing process and/or the substantive requirements for recognition of exemption under Section 501(c)(3):

- “Applying for Tax Exemption—An Overview” – a mini-course for new organizations thinking about applying for tax-exempt status. The course provides IRS resources that will make the process easier;
- Life Cycle of an Exempt Organization – explanatory information and links to forms an organization may be required to file during the five stages of its charitable life; and
- Form 1023 Educational Resources.

The Life Cycle of an Exempt Organization webpage, which may be found at <http://www.irs.gov/charities/article/0,,id=169727,00.html>, contains valuable information on the exemption application process and frequently asked questions that direct users to other resources within the IRS website.

One proposed resource for organizations applying for exemption under Section 501(c)(3)—Cyber-Assistant (CA)—proved unsuccessful. CA was conceived as a Web-based program to provide an applicant with a question-and-answer format and context-specific hints similar to current income tax software programs. When completed, CA generated a paper form with a two-dimensional bar code containing the application’s information. This paper form was to be mailed to Covington, where the bar coded information was scanned into the IRS system for processing consistent with the current paper process. The IRS anticipated offering a reduced filing fee for applications prepared with CA based on anticipated higher-quality applications and reduced review time.

Instead of establishing an electronic database as the core of the Form 1023 application process as recommended in the 2003 ACT report, CA sought to bridge the difference between the IRS’s current paper processes and the use of an electronic database method. Originally CA was intended to be available in 2007, but its software testing revealed some fundamental problems. The IRS has no current plan to resume development of CA.

## **G. 2003 ACT Report**

In May 2003, the Exempt Organizations Subcommittee of the ACT reported on its project studying the exempt organizations determination process, called Project ASPIRE.<sup>14</sup> The acronym “ASPIRE” stands for:

- A** - alleviate any application backlog
- S** - streamline the determinations process
- P** - prioritize application review
- I** - improve customer service
- R** - redirect resources to cases deserving enhanced review
- E** - enhance quality control

Project ASPIRE was a comprehensive review of the determinations process that was motivated in large part by a desire to streamline that process, thereby enabling the IRS to focus more of its limited resources on compliance rather than determinations.<sup>15</sup> In developing its recommendations for Project ASPIRE, the ACT “sought to take into account both the needs of TE/GE to administer an application review program in an accurate, complete, and impartial manner, and the needs of EO applicants for a determinations program that is accessible, comprehensible, reliable, and timely.”<sup>16</sup>

We commend the IRS for implementing some of the recommendations made in 2003 as part of Project ASPIRE. We note, however, that other recommendations have yet to be implemented and some of them—particularly the development of a fully e-fileable Form 1023—are even more urgent today than they were in 2003. We address some of the recommendations made in the Project ASPIRE Report in more detail later in this article.

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<sup>14</sup> Second Report of the Advisory Committee on Tax Exempt and Government Entities Public Meeting, May 21, 2003, *supra* note 12.

<sup>15</sup> *Id.* at I-1. In its report, the ACT made a number of recommendations for reforming the determinations process. These included the following, some of which the IRS has accomplished:

- develop a fully interactive Form 1023 (attempted via CA project);
- develop a fully e-fileable Form 1023;
- facilitate development of a Form 1023 database;
- develop a prominent Form 1023 “helpful hints” checklist (accomplished);
- conform the two public support tests;
- eliminate Form 8734 at the end of the advance ruling period (accomplished);
- identify the type of Section 509(a)(3) supporting organization in the Form 1023 and the determination letter (accomplished);
- develop a standard public charity reclassification process (accomplished);
- develop a standard “one-stop” name-change process; and
- link the IRS website to state charity officials’ websites (accomplished).

<sup>16</sup> *Id.* at I-5.

#### IV. Analysis of Changes to Make the Form 1023 More Effective, Consistent, Simple and Educational

##### A. Overview/Philosophy/Policy of the Form 1023

The ACT believes that Form 1023 should be redesigned to be more **effective**, **consistent**, **simple**, and **educational**. There is inherent tension in some of these goals, e.g., a more effective form may be a less simple one. Hence, the objective must be to strike the proper balance among these four goals, which we discuss in more detail below.

**Effective** – Form 1023 should be an efficient means of enabling the IRS to initially identify organizations that are, and those that are not, organized for a charitable purpose, as well as those organizations whose operations raise questions as to future compliance and therefore may be appropriate for later follow-up. While there are other values or goals that need to be balanced with effectiveness, we think that this summarizes what an effective Form 1023 should do.

For most organizations, the Form 1023 review process is the only time in a charity's life cycle when the IRS interacts with the organization in an individualized, one-on-one basis. In addition, the interaction between the IRS and an applicant at the Form 1023 stage is particularly important because it is early in the charity's life cycle, when it is easier for the organization to make the necessary changes to ensure future compliance. An effective determinations process should take advantage of this early opportunity to influence new Section 501(c)(3) organizations.

After the organization's application is approved, its normal interaction with the IRS consists of filing its annual Form 990. But because of the large number of 990 forms filed each year, the IRS cannot possibly respond to many organizations in a customized, "hands on" way.

Finally, the ROO process is another important component of an effective determinations process. Although organizations are not aware that they are being evaluated by the ROO, the process may lead to more direct IRS interaction with the organizations in appropriate cases. The ROO enables the IRS to approve certain applications more quickly by providing the IRS with a "safety net." That is, the IRS can follow up on organizations approved for exemption but flagged during the application process to verify whether their actual operations are as represented and in compliance with legal requirements. As we discuss in more detail later in this report, the ACT recommends that the IRS expand the use of the ROO to make it an even more important component of the overall determinations process.

**Consistent** – We believe that the substance, format, and terminology of Form 1023 and Form 990 should be more consistent, to the extent possible. For example, questions on Form 1023 (and even the order in which they appear on the form) should more closely mirror the

analogous questions on Form 990. And both forms should use consistent terms and definitions, which is currently not the case.

To be clear, we are not recommending that Form 1023 become a kind of a “mini” Form 990, with all its complexity and depth. However, the language used and the “look and feel” of the two forms should be consistent. With each passing year there is more common understanding about the questions asked on the recently redesigned Form 990. It would be helpful to both the IRS and the practitioner community if the questions on Form 1023 were more consistent with those on Form 990 so that some of those common understandings and interpretations could be transferred to the Form 1023 context. Also, making the two forms more consistent would benefit the organizations completing Form 1023. It would give these applying organizations a “preview” of the types of questions they will need to answer every year when they begin filing their 990 forms. It would also make it easier for state charity regulators and the general public to compare an organization’s planned activities and structure when seeking exempt status with its actual operations as reported on Form 990.

**Simple** – Form 1023 is not a simple document. The Paperwork Reduction Act Notice attached to the Form 1023 instructions states that the estimated average time required for recordkeeping, learning about the law or the form, preparing the form, and copying, assembling, and sending the form to the IRS is about 105 hours for the core part of the form. The corresponding time required for the eight schedules varies from about 7 hours to 18 hours. While we take these estimates with a grain of salt, there is no doubt that completing Form 1023 is a time-intensive process.

Of course, an individual’s perception about the relative simplicity of the form will depend, in large part, on the individual’s personal experience. Most of the practitioners we interviewed were tax professionals experienced with the form. While most of these practitioners believe that the 2006 revisions were a major improvement, they also agree that the form is now more complicated and time-consuming to complete. Nonetheless, most of them do not believe that the form is too burdensome; and some even suggested that the form be expanded to probe into areas such as whether the officers and directors understand the responsibilities of operating a charitable organization.

There can be no doubt, however, that completing Form 1023 is quite daunting to people who are not tax professionals. Setting aside the sheer number of questions on the form, most nonprofessionals probably don’t understand the implications of many of the questions. One consequence of making the form more complicated and time-consuming to complete is that it also becomes more expensive for organizations to hire tax professionals to assist with preparation of the form. One practitioner from a large law firm reported that the firm handles fewer 1023 forms on a pro bono basis than in the past, and some potential paying clients now go elsewhere to get assistance in completing the form. Fortunately, there are some reliable

and inexpensive resources available for people completing Form 1023 without professional assistance. Nonetheless, an important policy question is whether completion of Form 1023 should be a “high hurdle” or a “low hurdle” for an organization to obtain recognition of exemption. We discuss this issue further in our third recommendation dealing with small organizations and the consideration of whether there should be a shorter, less-complex “Form 1023-EZ” for such organizations.

**Educational** – While the primary purpose of Form 1023 is to provide the IRS with the information necessary for it to make a decision on the exempt status of an applicant, there are other important purposes that the form can and should serve. We believe that it is particularly important for the form to serve as an educational tool for new Section 501(c)(3) organizations. The vast majority of practitioners, we spoke with, believe that the thoroughness of the questions on Form 1023 has the salutary effect of forcing the applicant, while still in its “infancy,” to think systematically and practically about how it will operate. For example, precisely what activities the organization will engage in, how it will raise funds to support those activities, how much funding it can reasonably expect to raise, and what its budget will be. In effect, Form 1023 requires the applicant to develop something resembling a business plan.

The level of detail on Form 1023 is also helpful in signaling to applicants that they are entering into a complex regulatory environment with a strict set of rules. While most people who establish a new charity are good people and want to do good things, the thoroughness of Form 1023 helps underscore that tax exemption is a privilege that comes with responsibilities.

Related to this idea, several practitioners commented that Form 1023 questions actually function as a compliance tool. For example, through the questions on the form, organizations learn that they need to have organizing documents that include certain language. Said another way, the questions on Form 1023 inform applicants (at least indirectly) of many of the rules that govern exempt organizations. When there is some confusion about the meaning of a particular question on the form, it is likely that there is some rule that the organizers of the charity need to learn more about.

Most of the educational benefits of Form 1023 described above are indirect, i.e., they arise incidentally from the questions that are asked on the form. We recommend that the IRS be more intentional about using the form as an opportunity to educate applicants.<sup>17</sup> As discussed below, this could be done by reorganizing the content and structure of the form and using the instructions to provide better context for the questions. In addition to providing an

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<sup>17</sup> The IRS does acknowledge an educational purpose for the Form 1023. See IRS Comments to the National Taxpayer Advocate 2011 Annual Report to Congress, vol. 1, *supra* note 2, at 446 (“The Form 1023 also serves an educational purpose because it provides applicants either an introductory or a refresher course on the rules for tax exemption.”).

educational benefit to applying organizations, this approach may result in more responsive answers to the questions on the form and facilitate the review process.

## **B. Specific Recommendations**

**1. The IRS should expedite the internal processes and commit the necessary resources (human, financial, and technological) to transform Form 1023 into an interactive Web-based Form e-1023 that can be filed electronically and stored, transmitted, and disseminated in an electronic database format. This information will serve as the electronic gateway for IRS knowledge about tax-exempt organizations.**

In 2003, as part of Project ASPIRE, the ACT conducted a comprehensive review of the exempt organizations determination process and made recommendations for improvement. The first three recommendations were to:

- (1) develop a fully interactive Form 1023;
- (2) develop a fully e-fileable Form 1023; and
- (3) facilitate development of a Form 1023 database.

The ACT made a simple and straightforward case for these interrelated recommendations. With respect to the development of a fully e-fileable Form 1023, the ACT concluded that this “would save significant time in mailing, processing, assigning, and developing applications.”<sup>18</sup> The ACT further noted that this would enable the IRS “to more easily track applications, isolate specific application characteristics and trends, sort applications for data analysis, statistical and compliance purposes, and more efficiently make applications available to the public.”<sup>19</sup>

Since the ACT’s recommendation to develop a fully e-fileable Form 1023 was made in 2003, some 340,000 organizations have filed for recognition of exemption using Form 1023 in paper form. Although we estimate that as many as 90% of these organizations ultimately received recognition of exemption, the process for many was delayed because their forms had one or more common mistakes requiring IRS follow-up, making the exemption process slower and more costly for the organizations and the IRS alike. And all of the information about the Section 501(c)(3) sector reflected in those 340,000 applications—new developments, current trends, troublesome concerns, etc.—has been and remains largely inaccessible to state charity regulators and the public.

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<sup>18</sup> Second Report of the Advisory Committee on Tax Exempt and Government Entities, *supra* note 12, at I-12.

<sup>19</sup> *Id.*



The reasons cited by the ACT in 2003 remain valid today, but the case for development of a Form e-1023 has become not just compelling, but urgent. As the IRS clearly recognizes, we are no longer a paper-based society. The IRS has accepted electronically filed Forms 1040 for more than 20 years, enabling many taxpayers to handle their personal income tax filings on a paperless basis by completing the forms online, e-filing the returns, and storing copies electronically. The use of e-filing for Forms 1040 reduces mistakes, speeds up tax payments and refunds, and reduces the IRS burdens otherwise associated with processing paper returns.

These same advantages—and more—come into play in the context of the tax-exempt sector. Unlike Forms 1040, which are strictly between the IRS and individual taxpayers, Forms 1023 and 990 are required to be available to the public. This public availability promotes accountability and also serves to leverage IRS resources as attention is drawn to noncompliant organizations. The inclusion of Forms 990 on GuideStar has been of significant value in this regard and the inclusion of Forms 1023 could be expected to have a similar benefit. Moreover, research about the sector, using data from those forms, is relied on by funders, policymakers, state charity regulators, and other stakeholders. The transparency and accountability that results from public availability of Forms 1023 and 990 are central tenets of tax policy; and electronic filing can greatly enhance the attainment of these objectives.

The IRS already recognizes the advantages of electronic filing for tax-exempt organizations, as evidenced by its successful implementation of mandatory electronic filing of Forms 990 and 990-PF for many (but not all) filers.<sup>20</sup> The Form 990 electronic filing process, along with the Form 990 redesign made effective in 2008, has resulted in more accurate and complete Form 990 returns, significantly improved the quality of information available to the IRS, and increased the transparency of this information to the public.

Development of a Form e-1023 offers equal or greater promise. The principal benefits of developing a Form e-1023 include the following:

- (1) It will effectively and efficiently utilize IRS resources.

Although EO is a small part of the IRS, the 1.5 million exempt organizations regulated by the IRS have a substantial impact on the economy.<sup>21</sup>

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<sup>20</sup> Treas. Reg. § 301.6033-4 requires electronic filing of the Form 990 if the organization files at least 250 returns (W-2, 1099, employment tax returns, etc.) during the calendar year ending with or within the tax year and has total assets of \$10 million or more at the end of the tax year. The Form 990-PF is required to be electronically filed if the organization meets the 250-returns requirement; there is no asset threshold for private foundation returns. I.R.C. § 6011(e)(2) prevents the IRS from requiring electronic filing for taxpayers that file fewer than 250 returns annually with the IRS.

<sup>21</sup> TE/GE's EO Division currently employs approximately 900 of the IRS's 90,000+ employees.

“Virtually every American interacts with the nonprofit sector in his or her daily life through a broad range of concerns and activities such as health care, education, human services, job training, religion, and cultural pursuits. In addition, federal, state, and local governments rely on nonprofit organizations as key partners in implementing programs and providing services to the public. ... **Keys to a healthy nonprofit sector include strengthening governance, enhancing capacity, ensuring financial viability, and improving data quality without overly burdening the sector with unnecessary or duplicative reporting and administrative requirements.**”<sup>22</sup> (Emphasis added.)

“U.S. nonprofit establishments employed nearly 10.7 million paid workers in 2010. This accounts for 10.1 percent of our nation’s total private employment and makes the U.S. nonprofit workforce the *third* largest among U.S. industries, behind only retail trade and manufacturing.”<sup>23</sup>

The IRS has long recognized the business case and advantages of deploying technology, and currently upgrades its technological capabilities through its Business Services Modernization (BSM). In FY 2011, the IRS submitted an IT budget request of approximately \$2.67 billion of which \$2.3 billion constituted operations support and \$333 million for the BSM efforts.<sup>24</sup> These “efforts focus on building and deploying advanced information technology systems, processes, and tools to improve efficiency and productivity.”<sup>25</sup> They are consistent with the recommendations by the Electronic Tax Administration Advisory Committee’s “Annual Report to Congress,” which persuasively and consistently makes the overall case for the IRS to deploy electronic and Web-based technology.<sup>26</sup>

Transitioning to a Form e-1023 encompasses redesigning the form consistent with our second recommendation below and incorporating the inherent capabilities and efficiencies of a

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<sup>22</sup> *Nonprofit Sector: Increasing Numbers and Key Role in Delivering Federal Services*, United States Government Accountability Office, Testimony Before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives (statement of Stanley Czerwinski, Director, Strategic Issues, at 13) (July 24, 2007), [www.gao.gov/assets/120/117387.pdf](http://www.gao.gov/assets/120/117387.pdf) (last visited Mar. 27, 2012).

<sup>23</sup> Lester M. Salamon, S. Wojciech Sokolowski, and Stephanie L. Geller, *Holding the Fort: Nonprofit Employment During a Decade of Turmoil*, The Johns Hopkins Nonprofit Economic Data Project, 2012, at 2, [http://ccss.jhu.edu/wp-content/uploads/downloads/2012/01/NED\\_National\\_2012.pdf](http://ccss.jhu.edu/wp-content/uploads/downloads/2012/01/NED_National_2012.pdf) (last visited Mar. 27, 2012).

<sup>24</sup> *IRS Budget 2012: Extending Systematic Reviews of Spending Could Identify More Savings Over Time*, United States Government Accountability Office Report to Congressional Committees, April 2011, at 33, <http://www.gao.gov/assets/320/317693.pdf> (last visited Apr. 10, 2012). This report notes on page 33 that the “IRS funds one hundred fifty five IT systems. Of these, about 31 are considered ‘major’, each having an overall life-cycle cost of greater than \$50 million or an annual budget of greater than \$5 million. The other 124 systems are ‘non-major.’” Because a Form e-1023 project has not been subjected to a cost analysis to our knowledge, the ACT is unable to determine whether the development of a Form e-1023 will be considered a “major” or “non-major” project by these standards.

<sup>25</sup> *IRS FY 2013 Budget in Brief*, at 14, <http://www.irs.gov/pub/newsroom/budget-in-brief-fy2013.pdf> (last visited Apr. 10, 2012). We encourage the IRS to incorporate more information about the nonprofit sector in future reports.

<sup>26</sup> Given the Electronic Tax Administration Advisory Committee’s primary focus on broader technology needs, we encourage and welcome its future consideration for deploying electronic and Web-based resources to address the nonprofit sector and related exempt organizations. To read the Committee’s reports, see *Electronic Tax Administration Advisory Committee Annual Report To Congress*, Annual Reports for 2009-11, <http://www.irs.gov/efile/article/0,,id=213863.00.html> (last visited Apr. 6, 2012).

computer database. Because of the statutory bar on the IRS requiring e-filing for taxpayers filing fewer than 250 forms with the IRS, the ACT recommends that the IRS adopt a fee application structure that recognizes the efficiencies and quality control of using a Form e-1023 and encourages voluntary adoption as the sector's preferred method for seeking recognition of exempt status.

We recognize that Form e-1023 will require the significant deployment of assets at a time of significant competition for limited resources. We believe there is a strong and compelling business and tax policy case for investing the resources required now. We recognize, as did the 2003 ACT, the beneficial use of database technology to address the needs of this highly concentrated and impact-leveraged economic sector. We believe it is short-sighted not to begin to develop the efficiencies that Form e-1023 and related processes will provide to the IRS infrastructure.

- (2) “Streamlining the EO determinations process would enable EO to increase its focus on compliance, which is essential to the integrity of the tax-exempt sector.”<sup>27</sup>

Integrity is a bedrock of the nonprofit sector. Most exempt organizations are formed and operated by individuals who operate lawfully. These organizations maintain compliance through high-tech, high-touch communications that use cost-effective and efficient Internet and Web-based technologies such as the IRS website, the targeted email Exempt Organization Update, and other educational programs, including the Academic Educational Initiative developed by the IRS TE/GE Customer Education and Outreach initiatives. We believe that investing in these proactive compliance resources yields a significant return on IRS resources by improving sector compliance, avoiding IRS use of more expensive compliance assets, and achieving a high level of customer satisfaction.

Others may operate exempt organizations by means or for purposes inconsistent with the requirements of the tax laws, either intentionally or inadvertently. Compliance for these organizations requires the use of more expensive and time-consuming IRS resources such as the ROO, audits, and prosecutorial assets. We believe that development of Form e-1023, embedded with educational resources, will promote greater compliance from the inception of new organizations, lessening the need for more resource-intensive interventions.

During the intervening years since the 2003 ACT report, the IRS has benefited from its ability to fulfill its compliance function by investing in technology. Using a Form e-1023 application will increase and leverage the IRS's progress.

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<sup>27</sup> Second Report of the Advisory Committee on Tax Exempt and Government Entities, *supra* note 12, at I-1.

- (3) It will promote IRS processing by lessening delays.

Nine of the ten most common reasons for delay are clearly based on failure of an organization to provide required information initially with the Form 1023 application.<sup>28</sup> This lack of information and corresponding delay would be eliminated through electronic filing, which would review the application for completeness before a Form e-1023 application is accepted for filing.<sup>29</sup> Eliminating this delay will enhance productivity and speed up the review process.

The remaining reason for delay is insufficient information demonstrating how the exempt purpose will be achieved.<sup>30</sup> This delay arises primarily in response to the current Part IV Narrative question.<sup>31</sup> The response to this narrative question is at the core of the determination process. The electronic screening process can ensure that a Form e-1023 will not be accepted for filing without this information. It will, of course, not be possible to fully assess the adequacy of this information as part of the e-filing process. But we believe that a well-designed Form e-1023 can provide sufficient pop-up explanations and examples to significantly minimize the need for IRS follow-up with respect to the insufficiency of information. Use of Form e-1023 will thus increase the number of applications that can be approved without the need for follow-up contacts to applicants, enabling the IRS to more efficiently utilize its limited resources.

- (4) It will promote compliance through education and lessen filing mistakes.

The interactive component of Form e-1023 may have many of the same features as those intended for the unsuccessful CA tool, with the additional advantage of assisting the applicant in electronically filing an application for recognition of exemption, which was not a goal of CA.<sup>32</sup> In particular, the interactive component of the Form e-1023 would have the features that were described in the Project ASPIRE Report:<sup>33</sup>

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<sup>28</sup> See *Top Ten Reasons for Delays in Processing Exempt Organization Applications*, *supra* note 13.

<sup>29</sup> This verification process could include answering "yes" to the question about attaching the organization's articles and bylaws and confirming electronically that a PDF has been attached in response to that question.

<sup>30</sup> See *Top Ten Reasons for Delays in Processing Exempt Organization Applications*, *supra* note 13.

<sup>31</sup> The current Form 1023 requests the following in "Part IV Narrative Description of Your Activities": "Using an attachment, describe your past, present, and planned activities in a narrative. If you believe that you have already provided some of this information in response to other parts of this application you may summarize that information here and refer to the specific parts of the application for supporting details. You may also attach representative copies of newsletters, brochures, or similar documents for supporting details to this narrative. Remember that if this application is approved, it will be open for public inspection. Therefore, your narrative description of activities should be thorough and accurate. Refer to the instructions for information that must be included in your description."

<sup>32</sup> Because we are recommending the development of a fully electronic Form e-1023 filing system with an interactive component that contains the features conceived as part of the CA tool, we respectfully disagree with the National Taxpayer Advocate's recommendation that the IRS continue its development of the paper-based CA tool. National Taxpayer Advocate 2011 Annual Report to Congress, vol. 1, *supra* note 2, at 450 and 563.

<sup>33</sup> Second Report of the Advisory Committee on Tax Exempt and Government Entities Public Meeting, *supra* note 12, at I-11.

CyberAssistant, the fully interactive Form 1023 posted on the IRS website, could guide an applicant organization through Form 1023, explaining the need for and relevance of particular information, referring and linking to relevant IRS publications, defining essential and unfamiliar terms, and relating coordinated sections of Form 1023 to one another. By providing this background information, CyberAssistant would be able to eliminate “gotcha” aspects of certain Form 1023 questions for novice applicants, and identify circumstances in which an applicant does not qualify for exemption. For example, a “yes” answer to a question about political campaign intervention would result in pop-up advice from CyberAssistant that the organization is disqualified from section 501(c)(3) status, and a suggestion either to eliminate the activity or consider section 501(c)(4) status, with links to appropriate additional information and forms.

A Form e-1023 offers the opportunity to incorporate education about the requirements for exemption into the form itself. As discussed below, we believe that the IRS should use Form 1023 as a vehicle to provide more information about the requirements for obtaining and maintaining exemption. A Form e-1023 will facilitate that process.

Finally, the interactive component of a Form e-1023 filing system will also benefit the IRS. It would certainly improve the quality of the applications received by the IRS, reducing the workload on reviewers, who could process applications more quickly without having to request additional information from applying organizations.

(5) It will promote public transparency and accountability.

Development of a Form e-1023 is essential for the IRS to establish an electronic database of Section 501(c)(3) organizations—and creates an electronic “line of sight” for exempt organizations from their inceptions through their most current 990 forms. An IRS electronic database system will serve as the conduit by which information about these organizations is returned to the public in a usable electronic format. This will provide the public with direct access to the underlying raw data for subsequent electronic analysis and reports without the unnecessary burden or expense of translating this information from a paper to an electronic database format.<sup>34</sup>

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<sup>34</sup> This will permit analysis of the individual exempt organizations, as well as sectorwide analysis. Research organizations such as the Urban Institute; Harvard University’s Hauser Center for Nonprofits; North Carolina State University Institute for Nonprofits; Duke University’s Fuqua School of Business, Center for Advancement of Social Entrepreneurship; and others will have access to rich data resources for study and analysis. Policymakers, regulators, the exempt sector, the public, and the IRS will all derive significant benefits from the resulting research and knowledge. *See, e.g.,* Paul N. Bloom and Catherine H. Clark, *The Challenges of Creating Databases to Support Rigorous Research in Social Entrepreneurship*, Duke University’s Fuqua School of Business, Center for Advancement of Social Entrepreneurship, Working Paper (Nov. 2011), [http://caseatduke.org/documents/Articles-Research/Bloom-Clark\\_Database paper\\_Final\(workingpaper\).pdf](http://caseatduke.org/documents/Articles-Research/Bloom-Clark_Database paper_Final(workingpaper).pdf) (last visited Mar. 30, 2012).

Disclosure of the Form 1023 application is currently required after recognition of an organization's exempt status, at which time both the IRS and the exempt organization must produce a Form 1023 application and determination letter upon request by any party. Having this information readily available electronically on the IRS website provides the public with a one-stop, Web-based source for information about an organization's status and all publicly available IRS filings consistent with the "Exempt Organizations Select Check" Web page.<sup>35</sup> This provides the opportunity for an ongoing public examination and review of operating organizations that helps the IRS. When coupled with the publicly available Form 990, the IRS can leverage the exempt community, the public, and state charity regulators to enhance its own compliance, educational, and enforcement capabilities.

- (6) It will promote cooperation and collaboration with state charity regulators.

State charity regulators support development of Form e-1023 because e-filing will make the form more accessible to them and to the public in a cost-effective format.<sup>36</sup> The current capacity of state charity regulators to take advantage of a Form e-1023 is largely dependent on their ability to accept 990 forms either e-filed directly from organizations or as part of the federal/state data retrieval system. Since most regulators presently lack this capacity, their ability to benefit from e-filing will be subject to the limitations of addressing the additional costs of building necessary IT systems—something that will likely occur over time.

Forms e-1023 and 990 information should be readily and easily available to state charity regulators through the electronic data transfer of information with the choice to access this data made by state entities and others. Such information would help leverage IRS resources by providing an invaluable oversight tool for state charity regulators including enforcement against organizations that may not be operating in accordance with representations, made to the IRS, or the requirements for maintaining exemption, as well as referrals to the IRS for potential ROO reviews or audits.<sup>37</sup>

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<sup>35</sup> *Exempt Organizations Select Check*, <http://www.irs.gov/charities/article/0,,id=249767,00.html> (last visited Mar. 27, 2012).

<sup>36</sup> See Statement of the National Association of State Charity Officials to the United States Senate, Committee on Finance, *Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities* (June 22, 2004), available at <http://finance.senate.gov/imo/media/doc/062204mpptest.pdf> (supporting the IRS's development of electronic filing for the Forms 990).

<sup>37</sup> Such leveraging of IRS resources would help offset the practical barriers posed by the PPA to meaningful IRS leveraging of state assistance for predetermination inquiries and investigations. While the PPA expanded the categories of information the IRS may disclose to state charity regulators, in order to receive such information state charity regulators are required to maintain it with strict confidentiality. Only California, Hawaii and New York have entered into information-sharing agreements with the IRS, and those states have limited their receipt of information to paper documents to avoid the substantial burdens of maintaining safeguards required for the maintenance of electronic data. The reluctance of other states to enter into such agreements is based, in part, on the cumbersome nature of the safeguard requirements and the resources needed to adhere to them. Thus, the NAAG sent a letter signed by Attorneys General from 43 states (including California, Hawaii and New York) to the Senate Finance Committee on October 28, 2011, urging that Congress amend the provisions of Sections 6103, 6104 and 7213 to enable state charity regulators to more freely use information shared by the IRS. (See **Ex. 1.**) State charity regulators argue that the IRS's

**2. The IRS should redesign Form 1023 with four primary objectives: to make the form (i) *effective* at identifying whether organizations meet the requirements for recognition of exemption; (ii) *consistent* with the structures and definitions of Form 990; (iii) *simple* by using a short core form with supplemental schedules to reduce the filing burden on small and/or less-complex organizations; and (iv) *educational* by organizing questions based on substantive exemption requirements and including explanatory information.**

The ACT recommends that any redesigned Form 1023 track the legal requirements for exemption under Section 501(c)(3) and be organized, like Form 990, with a core form and schedules to be completed only if relevant. In general, the core Form 1023 should require basic factual information about the applicant including its organizational structure and planned activities and operations—thus demonstrating that it satisfies both the organizational and operational tests. The core form should also ask questions about potential activities that raise legal concerns or are considered “high-risk” activities from a Section 501(c)(3) perspective, with follow-up questions in appropriate schedules.

a. Identifying Information. In any redesigned Form 1023, Part I would generally remain, including Questions 1-12 of the current form that ask for basic information such as name, address, employer identification number (EIN), website, etc. The signature block and user fee information currently in Part XI should be moved to Part I, with the signature line being on page one to help minimize the filing of unsigned forms. The new form should require applicants to check a box indicating that they have determined the correct user fee from the IRS website and enclosed that fee with the application. The IRS’s Preparer Tax Identification Number (PTIN) system offers a good model for electronically paying a filing fee.

The instructions for the redesigned Form 1023 should continue to explain how to obtain an EIN, and should provide information about when that EIN should be used, such as when the organization opens bank accounts and on all forms filed with the IRS.

The ACT believes that Part I, Question 11 needs to be clearer. The question currently reads: “Date incorporated if a corporation, or formed, if other than a corporation.” Many times an organization starts as an informal arrangement, perhaps an unincorporated association, then it may move into fiscal sponsorship, and, later still, incorporate. Form 1023 instructions should make clear what information should be included in Form 1023 under these circumstances.

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application of understandable safeguards for the protection of confidential federal income tax information is particularly ironic given the inherently public nature of exempt organizations’ informational returns, and that release to them of nonpublic IRS information about exempt organizations should not be constrained by the same restrictive safeguards attached to the release of nonpublic information about taxpayers.



The current instructions remind each applicant that its website content should be consistent with the information provided on Form 1023; and the redesigned form should continue to emphasize this point. The IRS should note on Form 1023 that it will review an applicant's website to ensure that the information presented there also complies with the legal requirements under Section 501(c)(3). Form 1023 instructions should also include some examples of information that would raise concerns or generate additional questions from the IRS if present on the applicant's website. Such examples could include the following:

- the applicant states on its Form 1023 that it will not engage in lobbying activities, including grassroots lobbying. But its website provides a tool (or a link to the page of another organization that provides a tool) to “contact your Member of Congress,” which allows the user to click on statements regarding pending legislation of interest to the applicant and generate an email to the user's senator and representative asking them to take a particular position on such legislation. By making this tool available directly or through a link, the applicant is engaging in grassroots lobbying, which is inconsistent with the applicant's statement that it will not engage in lobbying activities. Therefore, the IRS will seek additional information to clarify this point;
- the applicant's website includes copies of press releases issued by the organization including one endorsing a candidate for elected office who has been an active supporter of the applicant. Because this violates the prohibition against electoral activity by Section 501(c)(3) organizations, the IRS will deny the application or require that the applicant remove this information from its website and not otherwise engage in such activities in the future; and
- the applicant's website solicits tax-deductible contributions, stating that “all contributions are tax deductible.” Because the IRS has not yet recognized the applicant's exemption under Section 501(c)(3), the applicant cannot present itself as having received IRS approval and should state that contributions “may be tax deductible” if its application is approved by the IRS. The IRS may request that the applicant clarify this point on its website before final Section 501(c)(3) approval is granted.

b. Organizational Requirements. To satisfy the organizational test, the governing instruments of the applicant must reflect the following requirements:

(i) It is organized exclusively for Section 501(c)(3) purposes only if its articles of organization limit its activities to furthering its tax-exempt (i.e., charitable or educational) purposes. Treas. Reg. § 1.501(c)(3)-(1)(b).



(ii) It is not considered organized exclusively for charitable purposes if its articles of organization expressly authorize it to devote more than an insubstantial part of its activities to attempting to influence legislation by propaganda or otherwise, or directly or indirectly participating in, or intervening in, any political campaign. Treas. Reg. § 1.501(c)(3)-1(b)(3).

(iii) It is not organized exclusively for exempt charitable purposes unless its assets are dedicated to an exempt purpose. An organization's assets will not be considered dedicated to an exempt purpose if, upon dissolution, the assets would, by reason of a provision in the organization's articles of organization or by operation of law, be distributed to the organization's members or founders or to an entity that will not use the assets to further exempt purposes. Treas. Reg. § 1.501(c)(3)-1(b)(4).

(iv) In addition, the organization may not be authorized to engage, more than to an insubstantial degree, in activities that are not in furtherance of one or more exempt purposes. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii).<sup>38</sup>

To collect the necessary information to demonstrate compliance with these requirements and encourage applicants to read the instructions, the second section of the redesigned Form 1023 should include the questions set forth in Parts II and III of the current Form 1023. The current instructions to Form 1023 provide useful background and educational information for applicants on these organizational requirements. To draw attention to this information, it would be helpful to include some very high-level guidance regarding these requirements on Form 1023 itself, and explain that the instructions include additional background and guidance. An e-fileable Form 1023 would include a link to the relevant section of the instructions.

The organizational section should also include other questions that relate to structural or governance-related issues that seem to flow from or be logically connected to these organizational requirements. Therefore, the organizational section of the restructured Form 1023 should ask the applicant if it is a private foundation or public charity, and have separate schedules that ask follow-up questions for each. The current Part VII of the form, "Your History," should be moved to the organizational section, as should Question 15 from Part VIII ("Do you have a close connection with any organizations? If 'Yes,' explain."). Finally, as is currently done on Form 990, Part VI, Section B, Form 1023 should include a series of questions relating to the applicant's policies (conflict of interest, whistleblower, and the like). These questions can be grouped together in the organizational section of Form 1023, as in Form 990, and the IRS can provide an introductory explanation of why these policies are

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<sup>38</sup> If the articles of organization authorize nonexempt activities to more than an insubstantial degree, the fact that an organization's actual operations have been exclusively for exempt purposes is not sufficient, and an application for exemption will be denied. Treas. Reg. § 1.501(c)(3)-1(b)(1)(iv).

necessary or helpful for a Section 501(c)(3) organization. If the applicant answers “yes” to any of these questions, the applicant should attach the relevant policy. Following the question about the applicant’s conflict-of-interest policy, the IRS should include Questions 5a-c from Part V of the current Form 1023, which request information about the procedures that are followed to ensure that persons who have a conflict of interest will not have influence over the applicant regarding business deals.

c. Operational Requirements. The third section of the redesigned Form 1023 should request information that will enable the IRS to confirm that the applicant is satisfying the operational test imposed on Section 501(c)(3) organizations. Under the operational test:

(i) An organization is considered to operate exclusively for exempt purposes only if it engages primarily in activities that accomplish one or more of its exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c).

(ii) An organization will fail the operational test if more than an insubstantial part of its activities is not in furtherance of an exempt purpose or if its net earnings inure in whole or in part to the benefit of insiders or others. Treas. Reg. § 1.501(c)(3)-1(c).

In the current Form 1023, Part IV, the applicant is asked to provide a narrative description of its past, present, and currently planned activities. Through this narrative description, as well as the financial data provided in Part IX of the current Form 1023, the IRS is able to determine if the applicant has engaged and will likely engage primarily in activities that accomplish one or more of its exempt purposes. These are, in many ways, the key sections of Form 1023. It is important that an applicant understand what is required in these sections. To better ensure that the IRS receives sufficient detail in these sections and that each applicant includes information regarding all its activities, the ACT recommends that the narrative section and the request for financial data be included in this third section and be restructured as follows:

- blank space should be inserted after the request for a narrative description, as was previously included in the pre-2006 Form 1023, to help ensure that an applicant provides a description of its activities. The form should clearly state that the applicant should continue its answer on an attachment, so that the applicant does not think that the level of detail requested by the IRS is limited to the space available on the form;
- the request for a narrative description should include suggested topics to address. For example, the form could explain that an applicant should provide a detailed description of all past, present or currently planned programs

conducted or to be conducted by employees or volunteers or in conjunction with other organizations. Instructing each applicant to attach newsletters and other materials is useful, but the form should also make clear that examples of the applicant's e-mail alerts, website postings and similar materials should also be printed and provided to the IRS as part of the application; and

- to make clear that the description of activities (currently provided in Part IV) should correspond to the financial information (currently included in Part IX), the ACT recommends that the request for financial data be moved to follow the narrative description. The request for financial data should specifically note that the activities described in the narrative description should be reflected in the financial data provided. For example, Form 1023 or its instructions could offer guidance such as “if you state in the narrative description of your activities that you expect to conduct educational seminars, your financial data should reflect the expenses and revenues relating to such seminars.”

d. Private Inurement and Private Benefit. A number of questions on Form 1023 request information about potential private inurement or excessive private benefit, which would be a basis for denial of recognition of exemption. These include questions currently in Parts V and VI of Form 1023 about compensation (both direct and indirect), conflicts of interest and contracts with officers and directors. It would be useful to group these questions together in one section, identify them as relating to private inurement and private benefit, and provide a very general overview of the private inurement and private benefit rules, noting that a more detailed explanation of these rules is included in the instructions.

To simplify the form for smaller, volunteer-run organizations, the ACT suggests that a short series of questions be included in the core Form 1023 and more detailed questions regarding compensation of officers, directors, employees and independent contractors be set forth on a schedule. The application, therefore, would ask a series of questions about whether the applicant has paid, or intends to pay within its first three years, compensation to (i) any employees, officers or directors, or (ii) independent contractors or other third parties. Similar questions (such as those currently asked in Part V of Form 1023) would be asked about purchasing goods, services, or assets from, or having leases, loans, contracts, or other arrangements with, any officer, director, trustee, employee, or highly compensated independent contractor.<sup>39</sup> For each question, if the applicant answers “yes,” it would be directed to a schedule that provides background information on the requirement that Section

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<sup>39</sup> The ACT recommends that the questions that currently ask for information about purchases from or arrangements with “highly compensated” employees should be expanded to ask about such purchases from or arrangements with any employee.

501(c)(3) organizations pay only reasonable compensation and asks detailed questions about the compensation paid or to be paid and how such compensation is or will be set. On the schedule, there would be a series of questions regarding the compensation and other payments made to organization insiders. These questions could include a chart similar to the compensation chart in Part II of Schedule J of Form 990. The schedule on compensation should also include the questions from Part I of Schedule J of the Form 990 (regarding first-class travel, how compensation is set, etc.).

e. Particular Activities. Part VIII of Form 1023 and a number of the schedules ask questions about specific activities that may raise issues for a Section 501(c)(3) organization. We recommend that the core Form 1023 include questions about these activities and that specific follow-up questions be asked in schedules. The current schedules from Form 1023 relating to specific activities or types of entities (i.e., schools, hospitals, entities conducting certain fundraising activities) can key off of questions asked in this section of the core Form 1023, as can other activities. For example, if an applicant is going to engage in publishing, the IRS should ask, in a schedule, a series of follow-up questions relating to publishing. Practitioners have found that if an applicant plans on engaging in certain activities—publishing or providing charitable services outside of the United States, to name just two—unless particular issues (unspecified in the questions or instructions) are addressed in Form 1023 as originally filed, the IRS will ask a series of follow-up questions. We believe that these follow-up questions likely could be avoided if additional questions were asked in a schedule, and the IRS provided educational guidance on the schedule and in the instructions regarding the issues raised by these particular activities. The IRS should, for example, develop a schedule for credit counseling organizations that reflects the provisions of Section 501(q).

f. Additional Issues. Form 1023 should be updated to reflect the elimination of the advance-ruling period for public charity status. Current Schedule B, Section II relating to racially nondiscriminatory policies of schools, colleges, and universities should allow such entities to publish their nondiscrimination policies online, rather than in a newspaper of general circulation. Schedule C, Hospitals and Medical Research Organizations, should be updated to take into account new Section 501(r) requirements. Schedule D relating to supporting organizations should be updated to reflect new PPA requirements.

g. Additional Considerations for a Redesigned Form 1023. In this section, we discuss several other considerations for redesigning Form 1023.

(i) “Do you or will you” questions – There are 46 questions on Form 1023 that begin with the phrase “Do you or will you.” Many of the practitioners we spoke with told us that the future tense expressed by the “will you” portion of these questions

creates significant uncertainty. Most organizations are still in their planning stages when they complete Form 1023, so they often struggle with how to answer the “will you” questions and whether they should check “yes” with respect to activities that they might someday conduct, even though there is no current intention to do so. For example, suppose a charity has no current intention of making foreign grants. It might, nonetheless, be reluctant to check “no” on Form 1023 because it may want to do so in the future and doesn’t want to be bound by its answer on Form 1023. But if it answers “yes,” this typically prompts a substantial number of follow-up questions from the IRS, which the charity may not yet be prepared to answer.

We recognize that information provided on Form 1023 forms a basis for reliance in the event of any later challenge to the organization’s tax-exempt status, and so it is generally advantageous for organizations to disclose potential future activities that have some reasonable likelihood of occurrence. It would be helpful, however, if the instructions to Form 1023 provided more specific guidance and clarity on how to interpret these “will you” questions. For example, the IRS could clarify that the “will you” questions are to be interpreted as whether the organization has any “current or specific” plans or proposals to do the activity in question. And the IRS should also emphasize that if the answers given on Form 1023 are made in good faith, then a later change in the organization’s plans will not necessarily result in any difficulties, provided that the change is properly reported to the IRS (on Form 990 or otherwise).

(ii) Sample conflict-of-interest form – With respect to Question 5, we believe that the sample conflict-of-interest policy given in Appendix A of the Form 1023 instructions should be substantially revised. It is our impression that some organizations adopt the IRS sample policy without much thought or consideration as to what it means for their particular organization—other than enabling them to answer “yes” to Question 5. And that would be the case with any sample conflict-of-interest policy provided by the IRS. We, however, have concerns about the specific sample policy in the current Form 1023 instructions.

A conflict-of-interest policy is important for several reasons including compliance with IRC Section 4958 relating to excess benefit transactions; and the current sample policy does not adequately address Section 4958 issues. For example, the current sample conflict-of-interest policy applies to “interested persons” (basically, officers and directors) who have a “financial interest” (as defined in the sample policy). But these interested persons are not necessarily the same as “disqualified persons” under Section 4958, leaving a significant gap in the coverage of the policy.

Moreover, some practitioners we spoke with believe that the sample policy was too narrowly focused on common financial conflicts to the exclusion of other types of business-related conflicts of interests. We believe that good corporate governance requires that these and

other types of issues be addressed in a conflict-of-interest policy. We recommend that the IRS review and update the sample conflict-of-interest policy as part of any overall revision of Form 1023.

(iii) Part IX, financial schedules – Some practitioners we interviewed commented that Part IX of the form is too complicated for nonprofessionals to complete. For example, it uses technical tax terms without adequate explanation (e.g., net unrelated business income). On the other hand, some practitioners told us that this part of the form should be more comprehensive and granular like the financial schedules on Form 990. In general, we believe that Form 1023 should be simpler than (but still consistent with) Form 990. In the context of these financial schedules, one reason we favor simplicity over comprehensiveness is that much, if not most, of the financial information provided on Form 1023 will be projections of future revenues and expenses that are necessarily speculative. It is difficult enough for applying organizations to develop good-faith projections of major categories of revenue and expenses (e.g., grants, salaries, and fundraising expenses) on Form 1023. To require them to make reasonable projections of revenues and expenses in very specific categories, similar to those used on Form 990, would be a fruitless and meaningless exercise.

(iv) Part X, private operating foundation status – In Question 4, Form 1023 provides two alternative means for an applying organization to demonstrate that it is a private operating foundation. In the experience of one practitioner, sometimes the narrative alternative is accepted without further inquiry, but in other cases it prompts a lengthy request for additional information. We believe that the form or the instructions should describe in more detail what the IRS is looking for in this narrative alternative. This would permit the applicant to address these issues when it submits the application, thus eliminating the need for the IRS to request additional information from the applying organization.

(v) Review of Form 1023 by the board – A new question should be added to Form 1023 asking whether the organization’s governing board has reviewed Form 1023 before submitting it to the IRS. (This is similar to Question 11 from Part VI of Form 990.) This will increase the likelihood that the board is aware of what the organization disclosed to the IRS.

**3. The IRS should develop more educational tools about Form 1023, including tips for filing Form 1023, and more information about the substantive requirements for recognition of exemption. The development of these tools, coupled with the redesign of Form 1023, should obviate the need for a separate “Form 1023-EZ” for small organizations. The ACT does not recommend development of such a form.**



The ACT seriously considered the merits of developing a separate, shorter Form 1023 (a “Form 1023-EZ”) for small organizations applying for recognition of exemption under Section 501(c)(3). For the reasons discussed below, we do not recommend this course of action.<sup>40</sup> We believe that the better approach is to make some structural changes to the current Form 1023 and develop more educational resources focused on the substantive requirements for exemption and Form 1023 itself, both of which will significantly ease the burden on small organizations.

a. Rationale for Not Developing a Form 1023-EZ – One of our stated goals for Form 1023 is that it be simple, and a shorter Form 1023 would almost certainly be simpler for small organizations. But we believe that the value of this increased simplicity would be outweighed by the loss of educational value to the applying organization and the loss of effectiveness to the IRS.

Before discussing the rationale for our recommendation regarding Form 1023-EZ, we first address a consideration that was *not* a basis for our recommendation—that Form 1023 should deter small organizations that are more likely to be formed without the necessary funding and infrastructure in place to survive long term from applying for recognition of exemption. We do not believe that Form 1023 should be a barrier to exemption for these organizations and we frankly suspect that the current form, with its complexity, has that effect. We hold this view while fully acknowledging that there are sometimes beneficial effects when the form does act as a barrier. But as a policy matter, we believe that Form 1023 should address the legal requirements for exemption in an effective, consistent, simple, and educational manner—nothing more, nothing less.

The primary reason we do not recommend the development of a Form 1023-EZ is because Form 1023 serves an important educational purpose for applying organizations. Through its questions, the form forces the applying organization to think somewhat deeply about its activities, finances, and management. The form also signals to the organization that it is entering into a (probably unfamiliar) comprehensive regulatory regime, and working through the questions on the form provides the organization with a great deal of information about compliance with this regime. We agree with the many practitioners we spoke with who believe that the educational benefits of Form 1023 are especially important for small organizations. And we do not believe that a significantly shorter Form 1023 could provide a comparable level of these benefits.

In addition, we think that it would be difficult to design a significantly shorter Form 1023-EZ that would still be effective from the IRS’s perspective, i.e., that it would still provide the

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<sup>40</sup> On this point, we respectfully disagree with the National Taxpayer Advocate’s recommendation to develop a Form 1023-EZ, as discussed in her most recent annual report to Congress. National Taxpayer Advocate 2011 Annual Report to Congress, vol. 1, *supra* note 2, at 450 and 563.

IRS with all the essential information it needs to make a determination on a small organization's exempt status. While the current Form 1023 clearly needs to be redesigned and streamlined, in the end many of the questions on the current form will still need to be asked (in some form or another) of all organizations, both large and small, although reformatting will reduce the need for smaller organizations to respond to certain questions. It should also be noted that many small exempt organizations will be Form 990-N (e-Postcard) filers. Hence, Form 1023 will be the only opportunity for the IRS to receive any substantive information about such organizations. Thus, it is even more important that 1023 forms filed by small organizations request all the information the IRS needs because there will not be a "second chance" to obtain this information later from a (full) Form 990 or Form 990-EZ.

While there is certainly abuse in both large and small charities, some practitioners and state charity regulators we spoke with noted that some types of small charities are particularly susceptible to abuse. In their view, some small charities seemingly do little more than pay salaries to their founders and insiders. It may also be easier to embezzle from a small charity because it has few or no staff and financial controls are perhaps not as strong as they should be. Moreover, small organizations often lack sufficient reserves to withstand such losses of resources. All these considerations are relevant to the application process for small organizations. The information an organization provides on its Form 1023 can sometimes signal to the IRS a potential for possible abuse, and the IRS can then "flag" that organization for later follow-up. Our concern is that a shorter Form 1023-EZ may be less capable of providing these warning signals.

State charity regulators uniformly oppose a Form 1023-EZ, noting that such a form would make it easier for "scam" charities to obtain Section 501(c)(3) status. They also believe that there is no way at the outset to justify a rationale of exempting small charities from the Form 1023 filing burden, because all applicants, other than perhaps private foundations, begin their existence as small organizations. As one state charity regulator noted: "The application process should be the same for everyone -- no one knows how large and successful a particular organization or cause may be at its earliest beginnings, even if they pledge to 'stay small.'"

Another objection to a Form 1023-EZ for small organizations is the difficulty in determining an appropriate standard for what "small" should mean for this purpose. If, for example, annual gross receipts are used as the threshold requirement for using the shorter Form 1023-EZ, this could frustrate the rationale for having the shorter form. An organization's projected gross receipts on Form 1023 could be substantially smaller than what it actually receives in its first few years. But because its projections were small, the organization would qualify to file the shorter Form 1023-EZ, and thus avoid providing the IRS, on a (full) Form 1023, with a more comprehensive view of this now "un-small" organization. More generally, if



projected annual gross receipts were used as the threshold for Form 1023-EZ, there would be a natural inclination for organizations to understate those projections.

b. Assistance for Small Organizations with the Form 1023 Application Process – Even though we do not recommend development of a Form 1023-EZ, the ACT strongly believes that the IRS needs to provide more assistance to small organizations applying for recognition of exemption. We offer several recommendations in this regard.

(i) Development of an interactive Form e-1023 – The ACT’s primary recommendation in this report is that the IRS should expedite the development of an interactive, Web-based “Form e-1023.” As discussed above, Form 1023 serves an important educational purpose, especially for small organizations. Moreover, the individuals completing Form 1023 for small organizations are frequently not experienced in the law of exempt organizations. They may be tax professionals who do not specialize in exempt organizations, but in many cases they are untrained volunteers who have never completed a Form 1023 before. Hence, the interactive component of Form e-1023 will be particularly helpful to small organizations.

(ii) Redesign of Form 1023 – We believe that small organizations will benefit greatly from a redesigned form. In particular, the use of more schedules and other design features will eliminate the need for many small organizations to struggle with inapplicable (and thus unnecessarily confusing) questions. For example, if an organization has no intention of having any employees or paying compensation to anyone (as is the case for many small organizations), there should just be a “box” it could check on the form. And many of the questions on Part V of the form, which would be inapplicable in this case, could be moved to a schedule that the organization would not have to complete.

(iii) Additional educational resources – The instructions to Form 1023 should be more user friendly, explaining the rationale for the questions on the form and providing more references and links to other documents on the IRS website, e.g., links to the relevant sections of the Life Cycle of a Public Charity document. (These features should also be integrated into the interactive component of Form e-1023.) As an example, in the Form 1023 instructions for Parts V and VI, or as a lead-in to the questions themselves, the IRS should just state that many of the questions in these two parts relate to private inurement and private benefit, and provide some simple, straightforward explanations of what the concerns are in this area. This context would be very helpful to people who are unfamiliar with these concepts. The IRS may also want to consider providing samples of properly completed forms, although we recognize that there is a risk that some organizations might mimic this information with the goal of becoming merely “paper compliant” in much the same way that organizations have adopted the IRS sample conflict-of-interest form. All

of these measures would be of enormous value to small organizations completing Form 1023; and the IRS would also benefit from having more complete and accurate responses to the questions on the form.

**4. The IRS should coordinate with the Department of the Treasury and the Office of Chief Counsel on the issuance of precedential guidance about the use of tax-compliant alternatives to the creation of new Section 501(c)(3) organizations, such as fiscal sponsorships and donor-advised funds.**

A concern expressed by some practitioners and state charity regulators is that many organizations may seek recognition of exemption under Section 501(c)(3) without exploring possible alternatives that might be more appropriate in light of their goals and objectives. The number of Section 501(c)(3) organizations that lost exemption as part of the Form 990 automatic revocation process and have not applied to regain exemption reinforces these concerns. Our sense is that many small nonprofit organizations obtain recognition of exemption under Section 501(c)(3) to carry out activities of relatively short-term duration. Examples include organizations created to receive memorial contributions or to raise funds for a specific short-term project—such as providing assistance following a local disaster, or construction of a new playground or dog park.

In these cases, the objective is to establish a vehicle to receive charitable contributions for a specific, time-limited purpose and not to create an organization that is intended to operate into the future. After these small, typically volunteer-run organizations navigate the Form 1023 process and obtain recognition of exemption, they may well run into a variety of tax compliance issues brought on by their lack of infrastructure and resources. These compliance issues may include failure to file the required Form 990-EZ or Form 990-N, failure to issue Forms 1099 or to comply with other federal or state tax requirements, or failure to comply with state charitable solicitation requirements. And, as noted, the organizations may be more vulnerable to fraud or theft because they lack basic internal controls.

There may often be alternative structures that could better serve the needs of these organizations—if only they knew about them. For example, community foundations and other sponsoring charities typically offer donor-advised fund options that may meet the needs of families who want to create a charitable fund to receive memorial donations. They may also act as fiscal sponsors for charitable projects in the community, such as playgrounds or dog parks, as could other like-minded Section 501(c)(3) organizations. Either of these options—setting up a donor-advised fund or a fiscal sponsorship with an existing Section 501(c)(3) organization—offers many advantages. These organizations have the ability to receive charitable contributions for specific projects, the infrastructure to ensure compliance with applicable federal and state laws and adequate internal controls to ensure that the funds will be used for the intended charitable purposes.

The IRS has recognized the value of working through existing charitable organizations rather than creating new ones in the context of disaster assistance. IRS Publication 3833 notes that in the immediate aftermath of a disaster or emergency situation, “those who wish to provide help may overlook existing charities and spend precious time and resources establishing a new charitable organization and applying for tax-exempt status.” The publication also observes that “it may be more practical to combine resources with those of an existing charity,” or to “see whether an existing charity operating in a related area may be interested in establishing a special program” to address the concern at hand.

We commend the IRS for offering this type of practical advice, which may help minimize the creation of new disaster relief organizations whose purposes can be equally or better served by existing organizations. The ACT believes that the IRS can and should do this in a broader context by including language along the lines of that contained in Publication 3833 in the instructions to Form 1023.

In addition, the IRS should coordinate with Treasury and the Office of Chief Counsel about the issuance of precedential guidance on the appropriate use of fiscal sponsorship arrangements. While our context for this suggestion is to minimize the unnecessary creation of Section 501(c)(3) organizations, we note that such guidance is frankly needed in any event. Although fiscal sponsorship arrangements are often used for large and sometimes complex projects, the only precedential IRS guidance in this area has to be gleaned from a 1966 revenue ruling issued in the context of “American Friends” organizations.<sup>41</sup> This ruling is more than 45 years old, and in the intervening decades fiscal sponsorship arrangements have become a significant part of the Section 501(c)(3) landscape. Most of the guidance in this area comes from a book published at the behest of several Section 501(c)(3) organizations in California that recognized both the potential for abuse and the need for guidance in this area.<sup>42</sup> From a tax compliance perspective, it would be useful for the IRS to issue precedential guidance in the area of fiscal sponsorship, and such guidance could be incorporated into educational information for new organizations about a legally permissible alternative to seeking exemption.

Another useful alternative is the creation of a donor-advised fund as a vehicle to receive charitable donations that will be granted for a charitable purpose. The IRS is currently working on guidance to implement the legislative changes affecting donor-advised funds that were made by the PPA. Such guidance could be a vehicle for confirming that donor-advised funds can be used, in appropriate cases, as alternatives to the creation of new Section 501(c)(3) organizations. The use of a donor-advised fund to hold memorial donations is a

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<sup>41</sup> Rev. Rul. 66-79, 1966-1 C.B. 48.

<sup>42</sup> GREGORY L. COLVIN, FISCAL SPONSORSHIP: SIX WAYS TO DO IT RIGHT (2d ed., Study Center Press 2005).

perfect example, and the IRS will have an opportunity to communicate this by including appropriate examples about these types of uses in its donor-advised fund guidance.

The ACT believes that state charity regulators may also be able to play an important role in disseminating this information, and we encourage the IRS to work with state charity regulators to develop coordinated approaches to inform new nonprofit organizations, or persons considering creating them, of legally compliant alternatives to seeking recognition of exemption under Section 501(c)(3).

**5. The IRS should carefully examine recurrent complaints about the Form 1023 filing and review process, and take expeditious steps to improve the effectiveness, efficiency, and timeliness of that process.**

As noted, the IRS has a well-developed process for ensuring quality control in the processing of 1023 forms and it also regularly assesses customer satisfaction with the filing process. The methods for ensuring quality control and assessing customer satisfaction are designed to gather information that is valid and reliable. The IRS uses such information to assess its procedures and make enhancements as appropriate.

As part of this project, the ACT has received feedback from various sources about the current Form 1023 application process. While this feedback is anecdotal and does not have the same validity and reliability as the data collected by the IRS through its own processes, there are some recurring themes and for that reason we offer it for IRS consideration. In addition to comments received from practitioners, we reviewed comments from the public on Form 1023 that were submitted through the Treasury Department's online Paperwork Reduction Act (PRA) tool. In its pilot project in 2010, the online PRA tool solicited comments on Form 1023 and received some 30 responses. Not surprisingly, many comments related to the length and complexity of the form, and the need for more educational information about how to complete the form. We address these issues in other sections of this report. But the PRA respondents also commented on the broader application process, which is the focus of this section of the report.

Common themes in the comments from practitioners and the PRA respondents are that the Form 1023 review process is too slow, some determination specialists are unresponsive or seem inadequately trained, and some requests for additional information ask for information that was already covered in the application or is unnecessary or duplicative. As noted, these comments are anecdotal and the ACT is obviously not in a position to assess whether these comments are reflective of the larger pool of applicants. We offer them in a constructive fashion, with the recommendation that the IRS consider them carefully with a view toward taking such appropriate corrective action as may be warranted.

While some applications are closed within a short period (as noted, in 2011 some 60% of Form 1023 applications were closed in less than 90 days), too many others are, in the view of practitioners, inexplicably delayed. A particular source of frustration expressed by both the practitioners and PRA respondents is the delay in assigning a reviewer to an application. On its website, the IRS provides some information about this type of delay.<sup>43</sup> For example, some applications requiring further development that were received by the IRS in July 2011 had yet to be assigned reviewers in March 2012—eight months later.<sup>44</sup> The ACT believes that the IRS should regard this level of delay as unacceptable and take steps to address it as quickly as possible.

Moreover, the practitioners told the ACT that applications referred to the Exempt Organizations National Office can take a very long time to process, sometimes several years. While we recognize that some applications involve difficult or novel issues that require significant time to process and coordinate with IRS Chief Counsel, the ACT believes that only in rare and exceptional cases should an application take more than a year to process, and we see no reason for any application to be delayed for several years. The ACT recommends that the IRS establish and implement internal deadlines to process all applications, including those referred to the national office.

Practitioners and the PRA respondents also raised concerns about uneven or inconsistent treatment of applications, i.e., complicated applications being approved quickly while simple applications are delayed, and virtually identical applications being treated differently. This variable treatment was attributed to the experience level of the determination specialist assigned to review the application. While the ACT cannot assess whether that is the case, this is something the IRS should explore and, if appropriate, implement additional training for specialists whose cases seem to take a long time to resolve. Respondents also noted a lack of responsiveness on the part of some determination specialists, e.g., not returning phone calls. One PRA respondent noted that it took two weeks to make contact with a specialist. We suggest that the importance of responsiveness be stressed as part of training sessions.

Finally, both the practitioner and PRA respondents expressed frustration about what they perceived to be unreasonable requests for additional information. Some practitioners note that all too often information requests suggest that the specialists did not read the complete application with care, or that they saw one “trigger” word in the application, e.g., the word “publish,” and reflexively sent a set of form follow-up questions. For example, one practitioner told us that it is not uncommon to see a request containing, say, eight questions where the practitioner’s response to six or seven of those questions will be simply “see page x of our application.” The ACT recognizes that the IRS has a responsibility to seek

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<sup>43</sup> See Internal Revenue Service, *Where Is My Exemption Application?*, available at <http://www.irs.gov/charities/article/0,,id=156733,00.html> (last visited Mar. 30, 2012).

<sup>44</sup> *Id.*

additional information as necessary to establish an organization's entitlement to recognition of exemption, and we are not in a position to determine how often requests for additional information may be unnecessary. We recommend that the IRS give careful attention to this feedback and take corrective action, if warranted.

**6. The IRS should expand its use of the ROO program to follow up on Section 501(c)(3) organizations whose Forms 1023 indicated potential future compliance issues, and should consult with state charity regulators regarding indicia that may warrant such follow-up.**

The IRS uses the ROO process to check on public sources for information about whether organizations are operating in compliance with the requirements for exemption as represented on their applications, and we believe that this is an excellent use of IRS resources. We believe that the ROO is a key part of ensuring an effective Form 1023 review process; and we recommend that the IRS expand the resources dedicated to the ROO in order to help identify, early on, organizations that may not be operating in accordance with representations made to the IRS, as well as the requirements for maintaining exemption.

The state charity regulators we spoke with believe that it would be useful to expand the ROO process to cover organizations that have operating characteristics suggesting potential future compliance issues. State charity regulators have identified certain types of organizations that, in their experience, are more apt to eventually be found out of compliance with the requirements for exemption.<sup>45</sup> They have also identified certain “red flags” that could signal potentially nonqualifying organizations,<sup>46</sup> as well as ways to better predict which applicant organizations may be prone to making misrepresentations, e.g., statements that a charity will be completely run by volunteers. One state charity regulator also suggested that Form 1023 should require signatures of each listed officer and director, since incorporators of sham charities often list phantom board members, including individuals who have not authorized use of their names and indeed are unaware that their names are being used.

We recommend that the IRS work with state charity regulators who may be able to identify categories of organizations that have a higher-than-average track record of engaging in fraudulent activities or impermissible private benefit, and might warrant follow-up through

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<sup>45</sup> State charity regulators told the ACT that these organizations often show indicia of private inurement or private benefit after obtaining exemption. These indicia may include certain organizations that claim to provide benefits to badge organizations (fire and police), organizations created by professional fundraisers, organizations that exploit the use of the terms “abused” and “battered,” and certain youth sports groups and nursery schools.

<sup>46</sup> These include organizations whose incorporators have a prior history of misconduct, such as an association with a revoked charity, a criminal background, and an affiliation with other charities that have been the subject of enforcement action.

the ROO process.<sup>47</sup> In our view, expanding the use of the ROO for these purposes would help the IRS make more effective use of its limited audit resources.

We believe that the ROO process can and should be used as a check and balance in the exemption process. Organizations seeking recognition of exemption under Section 501(c)(3) often have little, if any, actual operating history, since they often cannot obtain the funds needed to begin operations until they receive recognition of exemption. In some cases this may leave the IRS in an uncomfortable position—it must move forward to recognize or deny exemption based on representations about how an organization will operate, rather than an actual track record. The current IRS approach seems to involve asking many questions about the organization's anticipated operations—even though they have not yet commenced. At times this puts the organization in the unrealistic position of trying to guess what it will do under circumstances that may never occur, and the IRS in the difficult position of trying to assess the organization's credibility in answering questions that may be wholly hypothetical or simply premature. The net effect is often a considerable delay in processing Form 1023 as this back and forth continues.

The ACT believes that the IRS should expand its reliance on the ROO as a check and balance to allow the IRS to move forward with the favorable processing of 1023 forms for organizations representing that they will meet the relevant requirements but lack sufficient operating history to address IRS concerns. With greater use of the ROO process, the exemption can move forward but the IRS will have the assurance of knowing that there will be appropriate follow-up within a relatively short period.

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<sup>47</sup> By way of contrast, the IRS delays determination decisions when it believes that further predetermination investigations may demonstrate that applicants are currently engaging in fraudulent activities or impermissible private benefit. State charity regulators would like to collaborate in such investigations and believe that the IRS should be able to consult with them regarding information submitted by Form 1023 applicants and to verify applicants' responses to Form 1023 questions. The public is clearly better served by diligent investigation to prevent wrongful determinations in the first instance than by allowing misconduct to go unchecked until the ROO process and referral for resource-intensive IRS audits.

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## V. Recommendations

1. The IRS should expedite the internal processes and commit the necessary resources (human, financial, and technical) to transform Form 1023 to an interactive Web-based Form e-1023 that can be filed electronically and stored, transmitted, and disseminated in an electronic database format. This information will serve as the electronic gateway for IRS knowledge about tax-exempt organizations.
2. The IRS should redesign Form 1023 with four primary objectives: to make the form (i) **effective** at identifying whether organizations meet the requirements for recognition of exemption; (ii) **consistent** with the structures and definitions of Form 990; (iii) **simple** by using a short core form with supplemental schedules to reduce the filing burden on small and/or less-complex organizations; and (iv) **educational** by organizing questions based on substantive exemption requirements and including explanatory information.
3. The IRS should develop more educational tools about Form 1023 including tips for filing Form 1023, and more information about the substantive requirements for recognition of exemption. The development of these tools, coupled with the redesign of Form 1023, should obviate the need for a separate “Form 1023-EZ” for small organizations. The ACT does not recommend the development of such a form.
4. The IRS should coordinate with Treasury and the Office of Chief Counsel on the issuance of precedential guidance about the use of tax-compliant alternatives to the creation of new Section 501(c)(3) organizations, such as fiscal sponsorships and donor-advised funds.
5. The IRS should carefully examine recurrent complaints about the Form 1023 filing and review process and take expedited steps to improve the effectiveness, efficiency and timeliness of that process.
6. The IRS should expand its use of the ROO program to follow up on Section 501(c)(3) organizations whose exemption applications indicated potential future compliance issues, and should consult with state charity regulators regarding indicia that may warrant such follow-up.

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## Exhibit 1: National Association of Attorneys General Letter to the Senate Finance Committee Urging that Congress Amend the Provisions of Sections 6103, 6104, and 7213 of the IR Code



PRESIDENT  
**Rob McKenna**  
*Washington Attorney General*

PRESIDENT-ELECT  
**Doug Gansler**  
*Maryland Attorney General*

VICE PRESIDENT  
**J.B. Van Hollen**  
*Wisconsin Attorney General*

IMMEDIATE PAST PRESIDENT  
**Roy Cooper**  
*North Carolina Attorney General*

EXECUTIVE DIRECTOR  
**James McPherson**

October 28, 2011

The Honorable Max Baucus  
Chairman  
Committee on Finance  
United States Senate

The Honorable Orrin Hatch  
Ranking Member  
Committee on Finance  
United States Senate

*via fax*

Dear Chairman Baucus and Ranking Member Hatch:

Re: Pension Protection Act of 2006 Provisions Regarding Information

Sharing Between the Internal Revenue Service (IRS) and State Charity  
Regulators (Attorneys General)

### I. INTRODUCTION

We write to express our collective desire that Congress amend the provisions of sections 6103, 6104 and 7213 of the Internal Revenue Code (IRC). This request is intended to enhance the effectiveness of state charity regulators as well as the IRS by enabling state regulators to more freely use information shared by the IRS.

### II. BACKGROUND INFORMATION

State attorneys general typically have both common law and statutory oversight responsibilities over the charitable assets administered in their respective states including, but not limited to, testamentary and inter vivos trusts and foundations, individual and corporate fiduciaries, unincorporated associations, nonprofit corporations and their professional fundraisers and fundraising consultants. See Ex. A. There is a continuum of common law and statutory authorities that provide state attorneys general with broad regulatory responsibilities over the charitable sector.<sup>1</sup> Indeed, the common law authority vesting state attorneys general with these oversight authorities dates back to the Statute of Charitable Uses in 1601, predating by centuries our own federal tax code. Similarly, secretaries of state and state charity officials in other agencies responsible for consumer protection, licensing, or securities oversight in their respective states are vested with statutory authority over the activities of charitable organizations and their professional fundraising consultants and solicitors.

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Washington, DC 20036  
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<http://www.naag.org/>

<sup>1</sup> See STATE ATTORNEYS GENERAL POWERS AND RESPONSIBILITIES (Emily Myers & Lynne Ross, eds., 2007).

Although the specific functions of the IRS and state charity officials are distinct, they share a number of important objectives. While the IRS accomplishes its mission through the enforcement of our federal tax laws and state attorneys general apply state trust, nonprofit corporation, consumer protection, and charitable solicitations laws, the goals of these state and federal regulatory schemes often intersect—both state and federal regulators have material concerns about ensuring against excess compensation, private inurement, waste, fraud, conflicts of interest and other abusive practices. Despite these shared interests, however, a variety of constraints discussed more fully below on the IRS’s ability to share “tax return information” with state charity officials frustrate the synergies that would otherwise enhance the effectiveness of the limited enforcement resources available at both the state and federal levels.

It is commonly known that the IRS audits or examines less than one-half of one percent of all charitable organizations exempt under section 501(c)(3) of the Internal Revenue Code. It is also widely accepted that the IRS suffers limited resources to police the sector, in which, according to the National Center for Charitable Statistics, there are 1,127,287 tax exempt 501(c)(3) charities and private foundations administering over \$2,495,197,897,281 in charitable assets. Although federal law requires such organizations to make their informational returns (IRS Forms 990, 990EZ or 990 PF) available for public inspection and to state charity officials upon request,<sup>2</sup> prior to the Pension Protection Act of 2006, the IRS was precluded from sharing any other tax return information with state charity officials, including any instances in which the IRS may have discovered or received information or complaints concerning violations of state law. Widespread public access to the income, expenses and governance information of the charitable sector already allows the public and state charity officials to be the “eyes and ears” of the IRS by reporting abuses. In truth, the 50 state attorneys general and other state charity officials are on the “front lines” in regulating charities and annually refer many significant cases of abusive practices to the IRS Exempt Organizations Division.

The National Association of State Charity Officials (“NASCO”), which is affiliated with the National Association of Attorneys General (“NAAG”), has long advocated liberalizing the provisions of IRC §§ 6103 and 6104 to allow the IRS to freely share what is considered protected “tax return information” relating to charitable organizations. Such information-sharing would allow state attorneys general and other state charity officials to pursue cases that the IRS may lack the resources or authority to undertake, including the diversion of charitable assets by organizations in their respective jurisdictions where charitable assets are required to be deployed for the benefit of the public-at-large. In June 2004, NASCO testified to this effect before the Senate Finance Committee. See <http://finance.senate.gov/imo/media/doc/062204mpptest.pdf>

### III. THE PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 (the “Act”)<sup>3</sup> was intended to respond to the circumstances described above and allowed the IRS to unilaterally share tax return information with state charity officials and share other such information upon request. Regrettably, section 1224(b)(5) and (6) amended IRC §7213(a)(2) to make it a criminal offense for any state official to disclose

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<sup>2</sup> Federal treasury regulations also require private foundations to provide their IRS Forms 990PF to state attorneys general in their state of domicile or registration.

<sup>3</sup> Public Law No. 109-280 (Aug. 17, 2006).

information shared by the IRS under IRC §6104(c)(2). Despite the good faith efforts of the IRS Exempt Organizations Division to implement these amendments,<sup>4</sup> what was intended to facilitate the rigorous oversight of the charitable sector by state charity officials has failed to achieve its intended purpose.

#### IV. EXPLANATION OF THE PROBLEM

As a result of the Act subjecting information sharing between the IRS and state charity officials to IRC §7213's criminal penalties, the IRS has had to subject state charity officials, including state attorneys general, to the same informational safeguards imposed on the tax and revenue agencies of the 50 states. A copy of the 106-page IRS Publication No. 1075 that describes the multitude of safeguard procedures to which state charity officials must adhere may be found at the following URL: <http://www.irs.gov/pub/irs-pdf/p1075.pdf>.

These procedures not only create the ethical and legal conflicts described below, they are simply unworkable given the limited resources of state charity officials and should not apply to information regarding the revenue, expenses and governance data of charitable organizations already required to publicly report their financial and operational data. The IRS's understandable safeguards for the protection of confidential federal income tax information should be inapplicable.<sup>5</sup> These safe guards, for example, do not permit state charity officials to enter any shared data through a word processing program on any networked computer for inclusion in a civil complaint without complying with a myriad of security requirements that state charity officials do not have the resources to implement. Consequently, despite years of diligent efforts by state attorneys general to obtain information from the IRS, only three state Attorney General offices—New York, California and Hawaii—have entered into information-sharing agreements with the IRS since the adoption of the Act nearly five years ago.

Even the three states that have entered into information-sharing agreements have had to construct an uncomfortable “fiction” to use the data:

1. When the IRS makes a disclosure to the state charity office, an official reviews the data, logs the receipt of the information, and must place the data in a file secured by a least two barriers (doors, cabinets, etc).
2. In order to take investigatory or enforcement action, however, the state charity official must then rely upon an independent source, such as a telephone directory or advertisement, as the ostensible basis for contacting the subject charitable organization and requesting any recent communication to or from the IRS. Following this sort of procedure does not violate the safeguard provisions at issue because

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<sup>4</sup> State attorneys general acknowledge and commend the IRS's earnest efforts to administer these changes, educate state charity officials about the new requirements and make information sharing a reality. The IRS and state charity officials continue to enjoy an open dialogue about ways to improve charitable oversight. The comments expressed herein are in no way intended to criticize the IRS's implementation of the Act. The failure of this experiment is not the IRS's doing.

<sup>5</sup> Other than on unrelated business income, charities are exempt from income tax under IRC § 501(c)(3).

information provided directly by the charitable organization is not subject to IRC §§ 6103, 6104 and 7213.

3. If asked, a state charity official is prohibited from disclosing that the inquiry was premised on the information received from the IRS and must hope that the organization voluntarily produces all relevant information and, if not, issue a subpoena for the information.

In addition to the above, the rules of discovery are generally very broad and require disclosure of the tax return information in many, if not most, state jurisdictions. Although discovery rules are only applicable whenever civil or criminal proceedings are instituted, the fact that such disclosure may be required warrants careful consideration about the propriety of states withholding section 6104 tax return information and/or the fact of an IRS referral. The requirement that states must withhold disclosure of section 6104 tax return information will be especially sensitive whenever that information has prompted the state's inquiry. Most well-represented defendants demand to know all of the details underlying a state's enforcement action and are quick to exploit any suggestion of selective prosecution or prejudice due to a lack of candor concerning the identity, timing, or source of a complaint or the basis for the commencement of the action. Although state attorneys general are permitted to disclose and utilize section 6104 tax return information in judicial and administrative proceedings, discovery often occurs well in advance of such proceedings and the prejudicial effect of withholding such information from defendants until the time of trial is likely to risk court-imposed sanctions prohibiting the use of the information. From a practical standpoint, the discovery process will also result in the disclosure of information to third parties beyond the state's control (witnesses, court reporters, etc.).

Moreover, the security requirements create problems even when the shared information is not used to pursue an investigation or enforcement action. Some states have record retention laws that govern the return or destruction of state records which are likely to conflict with the provisions of section 6103(p)(4). Many states have their own versions of the federal Freedom of Information Act (FOIA) which may be sufficiently broad in scope to encompass the shared section 6104 return information. To the extent that return information under section 6104 is included within the scope of such statutes, states may be obliged to produce the information when requested.

In light of all of the above, states receiving section 6104 tax return information that cannot be used more straightforwardly are confronted with both ethical and legal dilemmas.

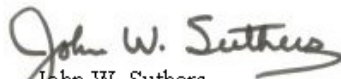
We see no reason why IRC notices of refusals to grant tax-exempt status, proposed revocations of exempt status, or proposed deficiency taxes for prohibited transactions under chapters 41 or 42, such as intermediate sanctions, taxes on self-dealing transactions and similar matters involving public charities and foundations, should be subject to the same criminal penalties and security procedures applicable to individual and corporate income tax return information. This is all extremely valuable and important information that allows state charity officials to fulfill their statutory mandate. The safeguard requirements have proven unsuccessful and unworkable,

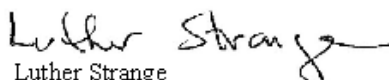
however, and even the three states that have attempted to “play by the rules” feel as if the information obtained directly from the affected charity is akin to fruit of a poison tree.<sup>6</sup>


As officials that represent state revenue and taxation agencies, we fully appreciate the fundamental public policy reason for the protection of confidential taxpayer return information—to encourage taxpayers to freely and voluntarily report their income and pay their fair share of taxes. Similar considerations should not apply to organizations that are exempt from income tax, that operate with the public subsidy of tax-exempt status, and who must already publicly report their income, expenses, governance data, disqualified person transactions, excess benefit transactions, changes in exempt purpose and governing documents, embezzlements and losses of funds, etc.—information that is then publicly available online at <http://www2.guidestar.org>.

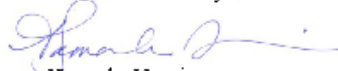
We urge Congress to remedy this situation by amending the federal laws to allow state attorneys general and other state charity officials to more freely obtain and use information possessed by the IRS to protect and promote the public interest we all share—that is, to ensure that charitable assets are lawfully administered at all levels of government.


Sincerely,

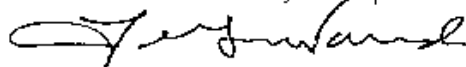
  
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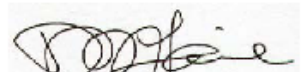
  
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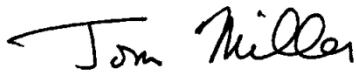
  
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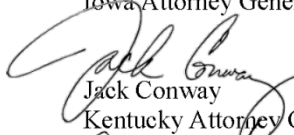
<sup>6</sup> Recently proposed IRS regulations (IRS REG-140108-08) will not address any of the substantive issues presented.

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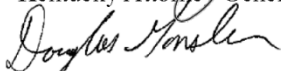
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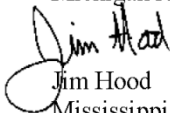
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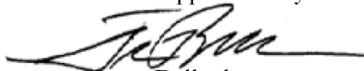
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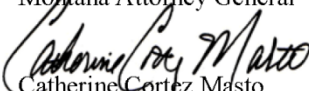
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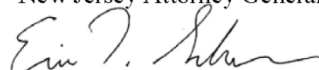
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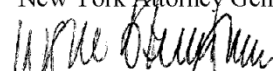
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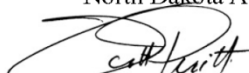
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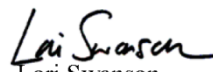
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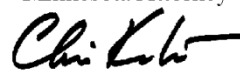
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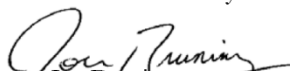
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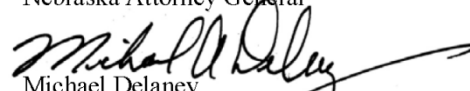
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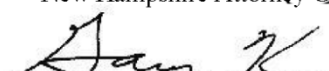
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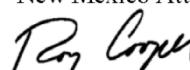
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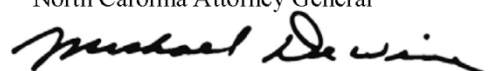
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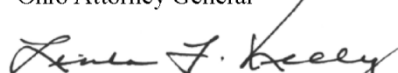
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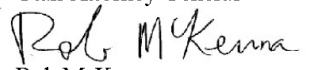
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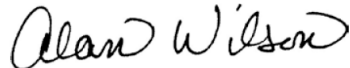
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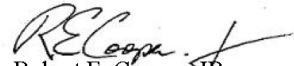
  
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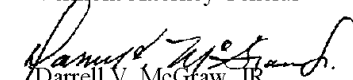
  
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**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Federal, State and Local Governments:  
TIN Matching as an Effective Online Business Tool to  
Improve Compliance**

Kathy Sheppard  
Lisa Pusich  
Robert Jaros  
FSLG Project Team

**June 6, 2012**

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## **I. Executive Summary**

### **A. Purpose**

The ACT/FSLG Sub-committee (Sub-committee) conducted a study to determine the usage of the Taxpayer Identification Number (TIN) Matching Program among federal, state, and local governments. The Sub-committee sought to answer the question of why only 1.17% of FSLG entities, who file information returns, use the TIN matching program, while 31.82% of these same entities receive a “B” notice or a backup withholding notice, a CP2100, or CP2100A notice. We sought to determine whether FLSG entities were aware of TIN matching, and if they were aware of TIN matching, but did not use it, what were the reasons for not participating in the program. We also gathered statistics to determine additional characteristics of businesses and non-businesses of the TIN matching program. We utilized four data sources to conduct this analysis:

- IRS Tax Gap Report – updated December 2011;
- FSLG historical compliance data;
- TIN Matching customer survey of state and local governments; and
- IRS data on government entity TIN Matching program participation with CP2100 error correlation for TIN matching users and non-users.

Based upon our analysis and discussions with IRS personnel, the Sub-committee has developed recommendations for the IRS to increase the use of TIN matching by government entities in an effort to improve compliance. The Committee believes, that by increasing the accuracy of information returns, the Service will improve overall reporting compliance which will reduce the tax gap while also reducing notice processing costs, both for the Service and the employers/taxpayers.

### **B. Background**

The IRS introduced the Taxpayer Identification Number (TIN) Matching Program in 2003. This program allows a participant to register with the IRS and transmit name/TIN combinations of payees (also referred to as “vendors” or “contractors”) to the IRS to determine whether the combinations match or mismatch. If the combinations match, the participant most likely has a correct payee name/TIN. However, if the combination is incorrect, the participant (also referred to as “business,” which includes government entities) will need to take further steps and could potentially receive a backup withholding or “B” Notice from the IRS for the payee with the mismatched TIN. The business can avoid these steps by using the TIN matching program and correcting mismatches prior to making further payments to payees with mismatched TINs. The TIN matching program allows the business to “do it right the first time,” and avoid further time and additional steps involved with mismatched TINs.

### **C. Survey**

The Sub-committee developed a survey to determine the extent of the usage of TIN matching and the reasons for using or not using the program. The Sub-committee initially distributed the survey through the National Association of State Auditors, Comptrollers, and Treasurers (NASACT). There were 27 states that responded to the survey. To hear from the various levels of local government, the Sub-committee reached out to state associations and the National Government Finance Officers Association (GFOA). There were 127 responses from local government officials working in finance and tax reporting. The Sub-committee did not survey federal agencies. The highlights of the survey are as follows:

- states are more likely to be aware of TIN matching than local governments – 96% of the states were aware of TIN matching vs. 45% for the local governments;
- states are more likely to use TIN matching than local governments – 77% of the states that are aware of TIN matching use it, while only 46% of the local governments that are aware of TIN matching use it;
- overall, for those responding to the survey, TIN matching is used by 74% of states and 20% of local governments;
- for local governments, the use of TIN matching did not depend on size – larger local governments were no more likely to use TIN matching than smaller local governments;
- for local governments responding to the survey, only 46% cited the IRS as the resource(s) that they used to address questions for 1099 and/or CP2100 reporting or follow up;
- for local governments that were aware of TIN matching, but did not use it, the most common reasons for non-use were that registration requires individual's social security number and cost/benefit not identified or costs exceed the benefits; and
- the survey results highlight the need for education and outreach to the non-state government entities and for improving the ease of use of TIN matching.



#### **D. Summary Recommendations**

1. **Consider expanding education and outreach on TIN matching, particularly to local governments.** This could include developing a website that outlines the benefits and ease of use of the TIN matching program, webinars on TIN matching, and presentations to local governments including both national (such as GFOA) and state organizations (such as each state's municipal league).
2. **Consider improving the ease of use of TIN matching.** This could include revising the registration process so that principals of businesses can designate users without users supplying their social security number and adjusted gross income. This also could include using the entity EIN rather than the individual SSN. Finally, the IRS could consider simplifying the process for resetting passwords.
3. **Consider improving the functionality of the TIN matching program to improve its perceived benefits to the user.** This could include a comment from the IRS on whether the payee is exempt or not. It could also include the entity type, as payee often marks "other" on the Form W-9. Finally, the match could be expanded to match the doing business (DBA) name, or include the DBA name in the TIN matching response.

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## **II. 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:

- enhancing enforcement of the tax code;
- enhancing taxpayer education and outreach; and
- modernizing the IRS through its people, processes, and technology.

The Tax Gap for the year 2006, published in 2012, and FSLG compliance checks and examinations identified 1099 reporting as a significant compliance issue. TIN matching program is an effective online business tool that can be promoted by the IRS to businesses to improve compliance with the tax code. In addition, TIN Matching will assist the IRS if proposed rules regarding TIN matching are implemented.

### **A. Tax Gap**

The net tax gap for tax year 2006 is estimated to be \$385 billion (see Appendix A). The net tax gap is defined as the amount of true tax liability that is not paid on time and is not collected subsequently, either voluntarily or as a result of enforcement activities. The tax gap estimate found that compliance is higher when reported amounts are subject to substantial information reporting and withholding, such as for wages and salaries compared with amounts subject to little or no information reporting, such as for nonfarm proprietor income, other income, rents and royalties, farm income, Form 4797 income, and adjustments. A measure of compliance is the net misreporting percentage (NMP) which is defined as the net misreported amount as a ratio of the true amount. The NMP is 1% for amounts subject to substantial information reporting and withholding and 56% for amounts subject to little or no information reporting, a category that includes form 1099 reporting. See Appendix B.

Payments to contractors are included in the category of amounts subject to little or no information reporting. Under 26 USC § 6041, service recipients (“businesses”) making payments aggregating to \$600 or more in a calendar year, to any non-employee service provider (“payee” also referred to as “vendor” or “contractor”) that is not a corporation, are required to send an information return to the IRS setting forth the amount, name, address, and TIN of the payee. Businesses also include FSLG entities that meet these criteria. Businesses provide Form 1099-MISC based on identifying information furnished by the payee on Form W-9, but not verified by the IRS. The present IRS code does not require businesses to verify the information received from the payee.

Businesses may verify the information received from the payee by using the IRS TIN matching program. Use of the TIN matching program has the following benefits:

- enhance enforcement of the tax code; and
- assist issuers of Form 1099 statements of income to avoid the backup withholding process.

## **B. FLSG Compliance and Examinations**

The issues found in compliance checks and in examinations were very similar. Worker classification and Form 1099 compliance issues were significant issues in both types of work. For compliance checks, 1099 issues were the most prevalent issue, and were found in 51.60% of the cases. For examinations, 1099 issues were also the most prevalent issue, and found in 37.50% of cases. See Appendices C and D (Top Ten Issues for cases closed in Fiscal Year 2007 thru 2009).

## **C. IRS Proposed Rules**

To further its goal of compliance, the Explanation of the Administration's Fiscal Year 2013 Revenue Proposals includes a proposal that businesses be required to verify the payee's TIN with the IRS using the TIN matching program. The proposal would be effective for payments made to payees after December 31, 2012. If legislated and implemented, awareness and use of TIN matching will need to substantially improve over present usage.

### III. Background

#### A. TIN Matching Program

The IRS introduced the Taxpayer Identification Number (TIN) Matching Program in 2003. This program allows a business to register with the IRS and transmit name/TIN combinations of payees to the IRS to determine whether the combinations match or mismatch. If the combinations match, the payee most likely has a correct name/TIN. However, if the combination is incorrect, the business will need to take further steps and could potentially receive a backup withholding or “B” Notice from the IRS for the payee with the mismatched TIN. The business can avoid these steps by using the TIN matching program and correcting mismatches prior to making further payments to payees with mismatched TINs. The TIN matching program allows the business to “do it right the first time” and avoid further time and additional steps involved with mismatched TINs.

#### B. IRS Publications

The IRS has issued two primary publications regarding TIN matching:

- Publication 2108A, *On-line Taxpayer Identification Number (TIN) Matching Program*; and
- Publication 1281, *Backup Withholding for Missing and Incorrect Name/TIN(s)*.

The Sub-committee reviewed both publications and believes that both are excellent resources for entities that issue Form 1099 statements of income and for those entities that receive backup withholding notices from the IRS. Publication 2108A includes the requirements for participation in the TIN matching program, the processes for the interactive and bulk TIN matching programs, an explanation of the codes that are sent back to the business, further resources to get help, questions and answers, screen prints, and troubleshooting. Publication 1281 includes frequently asked questions, actions to take for missing TINs and incorrect name/TIN combination, explanation of the TIN matching process (what is matched), flow charts for the first “B” notice and second “B” notice (including templates businesses can use to send to payees with mismatches), instructions for reading tape cartridges, and other forms.

FSLG also provided, to the committee, nine different PowerPoint presentations regarding information returns. For eight of these presentations, the main focus of the material was on the preparation and accurate reporting of 1099s with a few slides specifically related to the TIN matching program availability and benefits. One of the presentations was specific to the TIN matching program, which went into detail on the goals, application process, registration process, matching, and results. No data was available to measure the particular outreach efforts regarding the focus group or frequency of the training provided.

### **C. TIN Matching Registration Process**

In order to access the TIN Matching Program online, users are required to complete a registration form on-line with E-Services. They will create a user name, password, and PIN during this process. The IRS has an online tutorial available for IRS TIN Matching. The following information is required during this registration process:

- legal name;
- Social Security Number;
- date of birth;
- telephone number;
- email address;
- Adjusted Gross Income (AGI) from either current or prior year filed tax return;
- username selected;
- password PIN selected;
- reminder question for password reset; and
- home mailing address.

In order to authenticate users of the TIN Matching Program, the IRS utilizes the above information to validate with IRS return information and Social Security Administration information. The IRS current process only allows authenticated users access to the TIN matching program, and the authenticated users register with personal information. Once authenticated, a registration confirmation code is sent via the U.S. Postal Service. The user must then log back into the web site, within 28 days of the registration, and enter the confirmation code to complete the process.

### **D. Expired, Forgotten, or Lost Password or PIN**

If a participant has an expired, forgotten, or has lost either Password or PIN, the participant can use E-Services to reset the password online. There is an on-line tutorial to walk the participant through this process on E-Services. The user must enter the same information that was entered when the user originally registered. If the information matches, the user selects a new password and confirms it by entering the user's PIN. If the information does not match, the user must repeat the Authentication and Confirmation process. This includes creating both a new Password and PIN. For an expired password, the user's adjusted gross income must be provided to reset the password.

### **E. Notice and Correction Process for TIN/name Mismatch**

If there is a TIN/name mismatch on an information return, the IRS sends the payee a CP2100 or CP2100A notice. The payee compares the information on the CP2100 or CP2100A notice and corrects or updates its records, if necessary. If the CP2100 or CP2100A

notice matches the payee's records, then the payee has 15 days, from the date of receipt of the CP2100 or CP2100A notice, to contact the payee to obtain the correct name/TIN combination. Publication 1281 has a suggested form letter for businesses to send to payees to solicit the correct TIN/name combination. First and second notice payees are treated differently. If a payee has not appeared on a notice in one of the prior 2 years, then the payee must certify the correct TIN/name by submitting an IRS Form W-9. If the payee has appeared on one of the prior 2 notices, then the payee must submit a validated TIN/name by submitting documentation from IRS or SSA, depending on whether it is an SSN or EIN in question. If either type payee fails to submit the TIN/name within 30 days of the CP2100 or CP2100A notice, then the business must begin backup withholding at a rate of 28%.

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#### **IV. Project Process Including Survey Results**

The IRS provided the Sub-committee with research regarding the use of the TIN matching program by entity types. The result of that analysis was that only 1.17% of FSLG entities who file information returns use the TIN matching program, while 31.82% of these same entities receive a “B” notice or a backup withholding notice, a CP2100, or CP2100A notice. See Appendix F.

It was important to research the level of knowledge and use of the TIN matching program by government entities to determine the reason for these different percentages. Members of the Sub-committee are from state government, use the TIN matching program, and recognize its benefits. The Sub-committee developed a survey to assess the knowledge and use of the TIN matching program, by government entities at all levels of state and local governments. The committee also wanted to identify barriers impacting why TIN matching was not more widely used. See Appendix G.

The Sub-committee initially distributed the survey through the National Association of State Auditors, Comptrollers, and Treasurers (NASACT). There were 27 states that responded to the survey. To hear from the various levels of local government, the Sub-committee reached out to state associations and the National Government Finance Officers Association (GFOA). There were 127 responses from local government officials working in finance and tax reporting. The Sub-committee did not survey federal agencies. The highlights of the survey are as follows:

- states are more likely to be aware of TIN matching than local governments – 96% of the states were aware of TIN matching vs. 45% for the local governments;
- states are more likely to use TIN matching than local governments – 77% of the states that are aware of TIN matching use it, while only 46% of the local governments that are aware of TIN matching use it;
- overall, for those responding to the survey, TIN matching is used by 74% of states and 20% of local governments;
- for local governments, the use of TIN matching did not depend on size – larger local governments were no more likely to use TIN matching than smaller local governments;
- for local governments responding to the survey, only 46% cited the IRS as the resource(s) that they used to address question for 1099 and/or CP2100 reporting or follow up;

- for local governments that were aware of TIN matching, but did not use it, the most common reasons for non-use were that registration requires individual's social security number and cost/benefit not identified or costs exceed the benefits;
- the survey results highlight the need for education and outreach to the non-state government entities, for improving the ease of use of TIN matching, and for improving the perception of the benefits of TIN matching;
- for entities that received CP 2100 or CP2100A notices, the most likely action was to put the payee on payment hold (37% of respondents), while the second most likely action was to verify the information received from the payee (34%). Despite the potential contractual issues, entities are more likely to put a payee with a mismatch on payment hold because the entity has economic leverage of no payment until the TIN matching is resolved. Perhaps most concerning, from the survey, was that about 21% of respondents said that they take no action at the time of receiving the CP 2100 or CP 2100A notices; and
- overall, 31.82% of FSLG entities receive a "B" notice or a backup withholding notice, a CP2100, or CP2100A notice. Yet none of the respondents to the survey had a higher mismatch percentage than 16.67%. It is possible that entities that were aware of TIN matching, 1099 process, and backup withholding were more likely to respond to the survey. Statistically, non-responders must include entities with a higher mismatch percentage. It is these entities that need to be more aware of the TIN matching process, and could be more challenging to reach.

## V. Recommendations

1. **Consider expanding education and outreach on TIN matching**, particularly to federal and local governments.
  - a. **Develop a website for governments that outlines the benefits and ease of use of the TIN matching program.**
  - b. **Conduct webinars on TIN matching.** FSLG has agreed to host a webinar in FY 2012 to address 1099 issues and the benefits of TIN Matching.
  - c. **Conduct presentations to local governments**, including both national (such as GFOA) and state organizations (such as each state's municipal league).
  - d. **Conduct presentations to federal agencies** through the FSLG field group at the annual education seminars, or schedule webinars.
  - e. **Emphasize the benefits of TIN matching.** Federal, state, and local governments have faced lower budgets, staff reductions, and increased workload for the past several years. Faced with this situation, many of these entities have made a choice not to use TIN matching because of its perceived lack of cost/benefit. These entities would rather handle the mismatches through the backup withholding process at the end of the process rather than correct the TIN/name for all payees at the front end of the process. The IRS should include a cost/benefit of TIN matching in its presentations to overcome the perception that TIN matching is not worth the up-front effort, despite the substantial time that could be involved in the backup withholding process.
2. **Consider improving the ease of use of TIN matching.**
  - a. **Revise the registration process so that principals of businesses can designate users without users supplying their social security number and adjusted gross income.** Several entities that responded to the survey indicated that this is an area where they would like to see improvements. If an employer does not have an employee who is not willing to provide this personal information, they cannot participate in the TIN matching program. The survey indicated that 11 entities believed that providing personal information was a barrier to their participation in the TIN matching program. Even if employees are willing to participate in this registration process, it is not a guarantee that an entity will use the TIN matching program. In the survey, one state indicated that when a participating employee retired, their TIN matching program had to be suspended until another employee was willing to register for the program. As a result, there was a period of time in which no TIN matching occurred.

This is likely not an isolated issue and many states appear to struggle with this requirement.

- b. **Use the entity EIN rather than the individual SSN.** This would enable the principal at each entity to designate selected users of the TIN matching program, without these users registering and disclosing their personal information. The IRS currently provides for principals to designate individuals to discuss the entity's tax issues with the IRS. The IRS could consider a similar approach for the TIN matching program.
  - c. **Simplify the process for resetting passwords.** The requirement of AGI for resetting passwords creates delays, as this is typically information the employee does not maintain at work. The IRS could consider utilization of a secret question on password resets, and email this information to the user.
3. **Consider improving the functionality of the TIN matching program** to improve its perceived benefits to the user.
- a. In the response to the TIN matching, include a comment from the IRS on whether the payee is exempt or not.
  - b. In the response to the TIN matching, include the entity type, as payees often mark "other" on the Form W-9.
  - c. In the response, improve near match recognition to provide accurate name spelling when that is the cause of a mismatch.
  - d. Expand the match to include the doing business (DBA) name, or include the DBA name in the TIN matching response.
  - e. If TIN matching is taking longer than the normal 24-hour turnaround, the IRS should post a delayed processing notice on its website after 24 hours, and not wait until later.

## **VI. Conclusion**

The Sub-committee began the project with the information provided by the IRS that only 1.17% of FSLG entities who file information returns use the TIN matching program, while 31.82% of these same entities receive a “B” notice or a backup withholding notice, a CP2100, or CP2100A notice. The Sub-committee developed a survey and obtained responses from 27 states and 127 local governments. The survey results highlighted the need for education and outreach to the non-state government entities, for improving the ease of use of TIN matching, and improving the perception of the benefits of TIN matching. The Sub-committee developed recommendations to address these concerns for IRS consideration.

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## **VII. Special Thanks**

The ACT/FSLG Sub-committee wants to specifically thank a few individuals and organizations that assisted us on this project:

- Phyllis Burnside, Group Manager, Compliance and Program Management;
- Tennille M. Francis, Technical Advisor to the FSLG Director;
- Paul Marmolejo, Director, Federal, State and Local Governments;
- Scott Olson, Department Assistance Bureau Director, Office of the Comptroller of the Commonwealth of Massachusetts;
- Sallye Vandyne, IRS, Senior Program Analyst;
- National Association of State Controllers, Auditors, and Treasurers, and specifically Kim O’Ryan who assisted with the distribution of the survey to the states;
- National Government Finance Officers Association that also assisted in the distribution of the survey to the local governments. Susan Gaffney, Director, Federal Liaison Center, GFOA; and
- Alaska Government Finance Officers Association, President Walter Sapp.

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## Appendix A: Tax Compliance Comparison (Net Tax Gap) TY2001 and TY2006

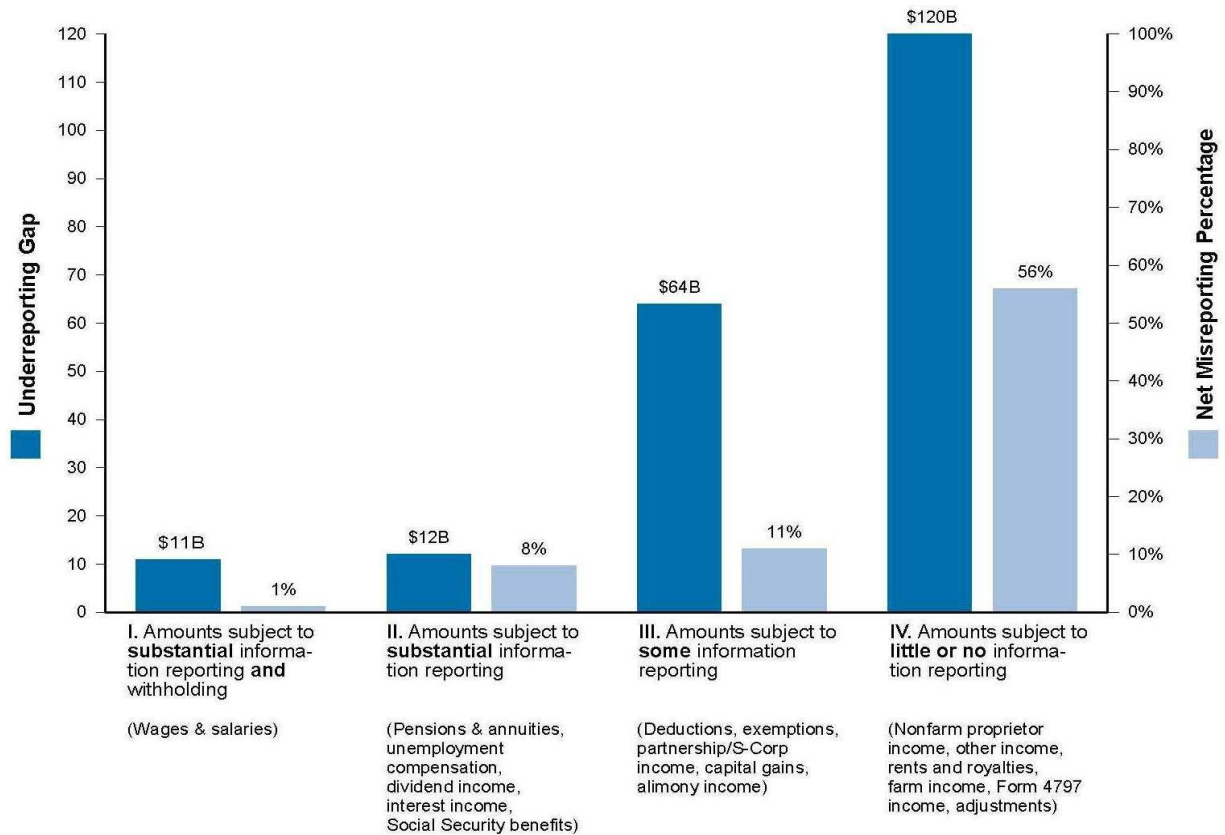
	Tax Year 2001 (billions)	Tax Year 2006 (billions)
Total Tax Liabilities	\$2,112	\$2,660
Gross Tax Gap	\$345 (83.7% compliance)	\$450 (83.1% compliance)
Enforcement and Late Payments	\$55	\$65
Net Tax Gap	\$290 (86.3% compliance)	\$385 (85.5% compliance)

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## Appendix B: Effect of Information Reporting on Taxpayer Compliance

**Chart 1: Effect of Information Reporting on Taxpayer Compliance**

Tax Year 2006 Individual Income Tax Underreporting Gap and Net Misreporting Percentage, by "Visibility" Category



NOTE: Net Misreporting Percentage is defined as the net misreported amount of income as a ratio of the true amount.

Internal Revenue Service, December 2011

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**Appendix C: Top Ten Issues Identified for Compliance Checks Closed During Fiscal Years 2007 thru 2009**

<b>Issue</b>	<b># Cases</b>	<b>% Cases</b>
1099 Issues	1300	51.60%
W-9 Issues	969	38.50%
Worker Classification Issues	403	16.00%
W-2/W-3 Issues	402	16.00%
Personal Use—Employer Property	400	16.00%
Day Meals	351	13.90%
Payment Re-characterization Issues	166	6.60%
W-4 Issues	143	5.70%
Accountable/Non-accountable Plans	132	5.20%
Section 218 Coverage Issues	111	4.40%

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## Appendix D: Top Ten Issues Identified for Examinations Closed During Fiscal Years 2007 thru 2009

Issue	# Cases	% Cases
1099 Issues	520	37.50%
Worker Classification Issues	419	30.30%
Personal Use-Employer Property	352	25.40%
W-9 Issues	282	20.40%
Non-Taxed Allowances	245	17.70%
Payment Re-characterization Issues	241	17.40%
Day Meals	239	17.30%
Accountable/Non-accountable Plans	182	13.10%
Other-Wage Issue	157	11.30%
W-2/W-3 Issues	135	9.70%

Definitions of these terms are in the Glossary in Appendix E. A table displaying the trending of Issues Identified in FSLG compliance checks and examinations can be found in Appendix C.

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## Appendix E: Glossary of Terms for FSLG Issues listed in Appendices C and D

<b>Term</b>	<b>Definition</b>
1099 Issues	Non-compliance with Forms 1099 filing
Accountable/Non-accountable Plans	Issues concerning employee expense plans such as reimbursements, allowances, etc.
Employer provided Automobiles	Issues related to employer provided vehicles
Back Pay and Damage Awards	Incorrect tax treatment of employment based settlements
Backup Withholding	Issues concerning non-wage income tax withholding
Day Meals	Incorrectly excluded fringe benefit
Employee Plans Adjustments	Issues concerning pension and benefit plans
Employer provided Automobiles	Issues concerning use of employers vehicles
Equipment & Allowances	Issues concerning use of employer provided equipment and/or allowances
FICA tax issues – Other	Mandatory Social Security and Mandatory Medicare and various other FICA tax reporting errors.
Fringe Benefits – Other	Issues concerning “other” fringe benefits such as cash in lieu of insurance, spousal travel, allowances, gift cards, and similar items.
Group Term Life Insurance	Incorrect reporting of group life insurance benefits
Medicare Continuing Employment Exception	Issues concerning the pre-1986 Medicare exclusion
Moving Expense Reimbursements	Incorrectly reported moving expenses
Non-Taxed Allowances	Issues concerning payments made for benefits which were not documented
Other-Wage Issue	Other categories of wage issues
Payment Re-characterization Issues	Re-characterization of payments as wages
Personal Use-Employer Property	Issues related to personal use of employer equipment
Salary/wages	Wage adjustments
Section 218 Coverage Issues	Issues concerning Section 218 Agreements
Standard Items of Compensation	Issues concerning taxability of various “other” standard compensation items such as bonuses, stipends, other miscellaneous payments, etc.
W-2/W-3 Issues	Issues related to Forms W-2/W-3
W-4 Issues	Issues concerning Forms W-4.
W-9 Issues	Issues related to Forms W-9 Request for Taxpayer Identification Number
Worker Classification Issues	Treatment of employees as independent contractors
Worker Classification Issues-CSP	Worker classification issues eligible for Classification Settlement Program

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## Appendix F: CP 2100 Error Rates for FSLG TIN Matching Users and Non-Users

Employment Code	A Fiscal Agent	F Federal Agencies	G State & Local, No 218 Agreement	T State & Local, 218 Agreement	State Data	TOTALS
FSLG customers total count (9-30-2011)	223	2,842	48,869	57,870		109,804
FSLG users who filed at least one of the 7 info returns*	25	2,802	21,875	39,921		64,623
FSLG entities that filed info returns & had CP2100 notices issued for 2010	14	178	5,662	13,928	783	20,565
Percent of FSLG entities with CP2100s issued						31.823%
TIN Match users - completed application process	7	40	168	404	138	757
Percent of FSLG Entities who file info returns* and are <u>Registered IRS TIN Match Users</u>						1.171%

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## Appendix G: CP 2100 Error Rates for All TIN Matching Users and Non-Users

Employment Code	A Fiscal Agent	F Federal Agencies	G State & Local, No 218 Agreement	T State & Local, 218 Agreement	State Data
<b>Total of all 7 Info returns filed by TIN Match – <u>FSLG Non-Users 2010</u></b>	16,468	580,955	781,724	1,596,948	1,013,791
<b>Total returns identified on CP2100 Notice 2010 TIN Match – <u>FSLG Non-NON Users 2010</u></b>	537	22,254	33,267	90,215	5,993
<b>CP2100 - Error rates**, IRS TIN Matching <u>FSLG Non- Users</u></b>	3.261%	3.831%	4.256%	5.649%	0.591%
<b>Total of all 7 Info returns filed by TIN Match Users 2010</b>	-	-	235,689	785,774	1,718,090
<b>Total returns identified on CP2100 Notice 2010 TIN Match Users 2010</b>	-	-	5,502	13,525	5,425
<b>CP2100 - Error rates, IRS TIN Matching Users</b>	0.000%	0.000%	2.334%	1.721%	0.316%

\* Forms 1099-B, 1099-DIV, 1099-INT, 1099-MISC, 1099-PATR, 1099-OID, & W-2G

\*\* Error rate is determined by comparing the number of Forms 1099-B, 1099-DIV, 1099-INT, 1099-MISC, 1099-PATR, 1099-OID, & W-2G filed by each entity with number of the same returns identified on that same year CP2100 Notice.

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## Appendix H: TIN Matching Survey

### TIN Matching Survey

1. How many Vendors/Payees (unique TINs) does your entity manage? \*
  - 1a. What is your standard vendor registration and verification process? \*
  - 1b. If your entity has more than one EIN which you report through, is your vendor registration and verification process the same for each of your EINs (if not, would you explain differences in process)?
2. For your 2010 fiscal year, what was the total amount of your entity's expenditures, on government wide basis, excluding payroll? \* Threshold of expenditures (excluding payroll)
  - ☐ less than \$5,000,000
  - ☐ less than \$50,000,000
  - ☐ less than \$100,000,000
  - ☐ less than \$1,000,000,000
  - ☐ \$1,000,000,000 or more
3. For the tax year 2010, by tax form, how many 1099's did your entity issue and what was the total amount reported by form type?

Please complete all forms that apply (Applicable forms are listed at the bottom of this survey)

  - ☐ 1099-MISC - enter # Issued
  - ☐ 1099-MISC - enter Total Amount
  - ☐ 1099-INT - enter # Issued
  - ☐ 1099-INT - enter Total Amount
  - ☐ W2G - enter # Issued
  - ☐ W2G - enter Total Amount
  - ☐ Other - enter # Issued (applicable forms listed at the end of this survey)
  - ☐ Other - enter Total Amount (applicable forms listed at the end of this survey)
4. Did your entity receive a CP2100 or CP2100A (also referred to as B-Notices - definition at the bottom of this survey) for tax year 2010?

If yes, enter the number of mismatched items for each type below (enter all that apply)

- ☐ CP2100 /CP2100A for form 1099-MISC - # received
- ☐ CP2100 /CP2100A for form 1099-INT - # received
- ☐ CP2100 /CP2100A for form W2G - # received
- ☐ CP2100 /CP2100A for Other forms - # received

5. What action(s) does your organization take when your entity receives CP2100 or CP2100A? Check any that apply

- ☐ Perform backup withholding
- ☐ Suspend payments to vendors
- ☐ All vendor actions put on hold
- ☐ No action at this time
- ☐ Other

6. Have you heard of the IRS on-line Taxpayer Identification Number (TIN) Matching Program? \*

- ☐ Yes
- ☐ No

7. Does your organization use the TIN Matching Program?

- ☐ Yes
- ☐ No

7a. If yes, what calendar year did your entity begin using the IRS Tin Matching Program?

8. If your entity now uses the TIN Matching Program, what is the reduction in number of mismatches (percentage) you have experienced? Please compare number of returns the last time no verification was done to your latest year using TIN Matching Program?

- ☐ No measurable change
- ☐ < 20%
- ☐ < 50%
- ☐ Greater than 50% reduction



9. If you are using the TIN Matching Program, how do you use it?

- ☐ We use TIN Match centrally with multiple agencies requesting through our office
- ☐ We have several agencies use the TIN Matching program at their site for their records
- ☐ We have multiple TINs and use TIN Match for our validations - other agencies may or may not use separately under their agency's TIN
- ☐ Other

10. Do you have any suggestions on how the IRS FSLG (Federal, State and Local Governments) could improve this program?

11. If you have heard of the TIN Matching Program, but have not used it, what is the reason? Check all that apply

- ☐ Technology
- ☐ Cost exceeds benefits
- ☐ Cost / benefit not identified
- ☐ Additional time to set up a vendor
- ☐ Registration process requires individual's SSN
- ☐ Do not usually use IRS products
- ☐ Other

12. What resource(s) do you use to address your questions for 1099 and/or CP2100 reporting or follow-up? \*

13. Type of government entity \* Check One

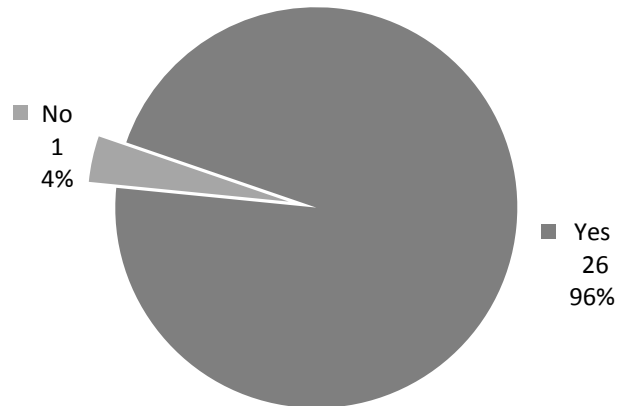
- ☐ Federal
- ☐ State
- ☐ County
- ☐ City
- ☐ Town
- ☐ Independent Authority
- ☐ Non-Government

14. Position of Individual completing the survey

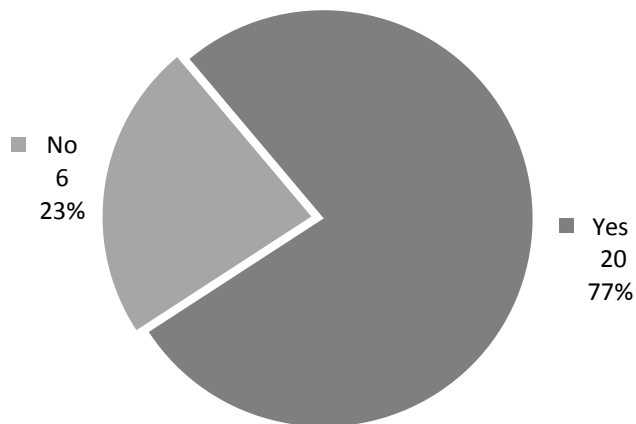
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**Appendix I: State Responses to TIN Matching Program Recognition and Use  
(from ACT Committee Survey)**

**Have you heard of the IRS on-line Taxpayer  
Identification Number (TIN) Matching Program?**



**If yes, does your organization use the  
TIN Matching Program?**



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## Appendix J: Non-State Government Entities Responses to TIN Matching Program Recognition and Use (from ACT Committee Survey)

**Have you heard of the IRS on-line Taxpayer Identification Number (TIN) Matching Program?**

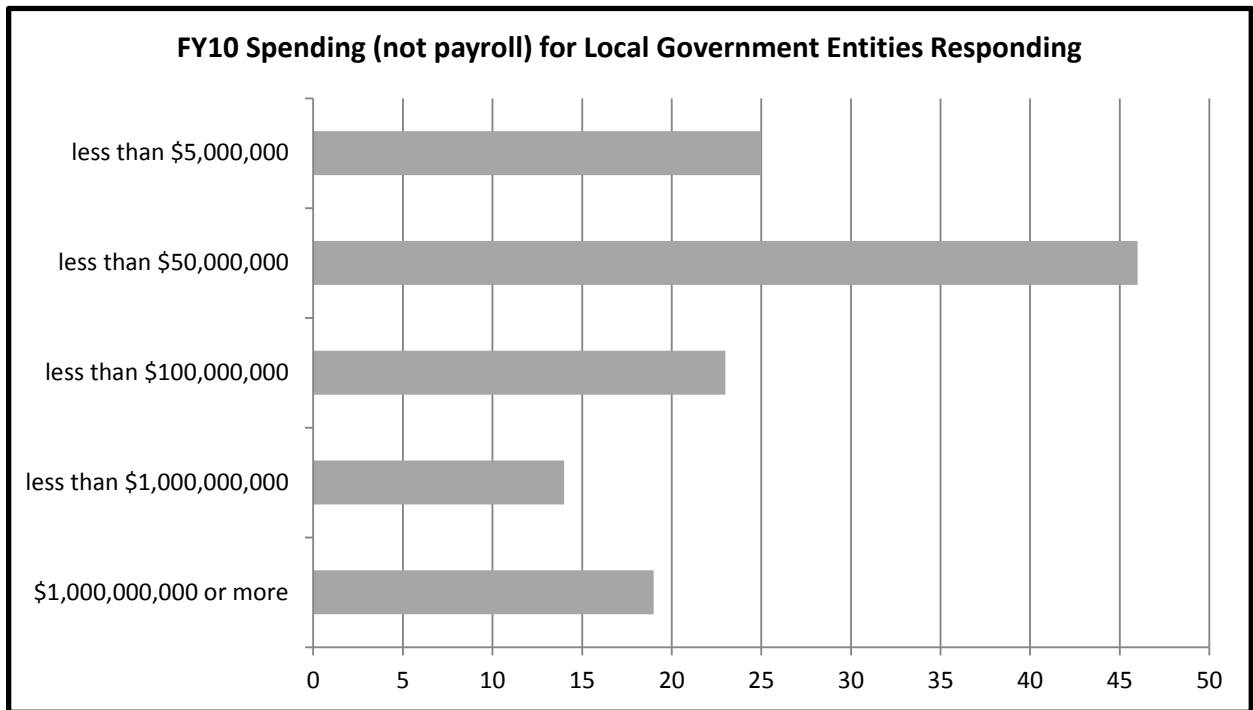


**If yes, does your organization use the TIN Matching Program?**



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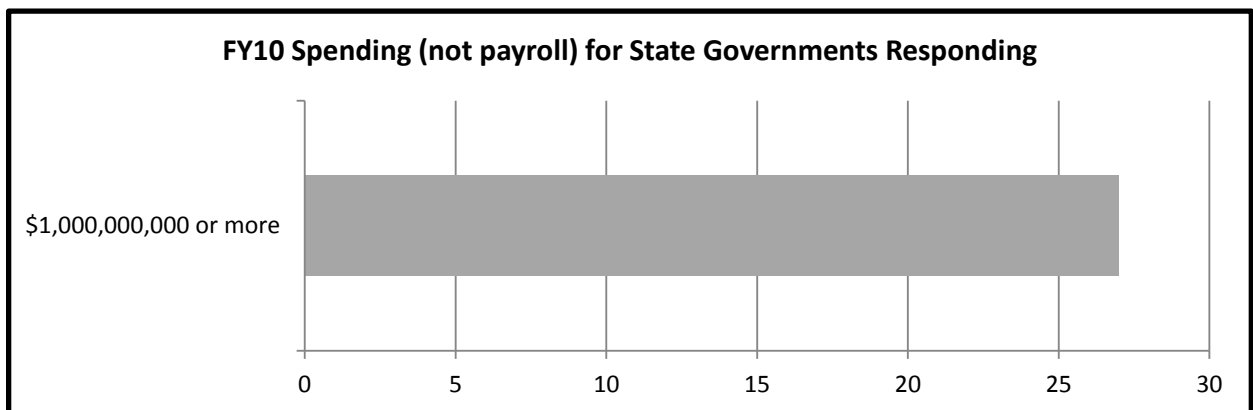
## Appendix K: FY10 Spending for Responding State and Local Governments



### Non-State Entities Breakdown

\$1,000,000,000 or more	19	15.0%
less than \$1,000,000,000	14	11.0%
less than \$100,000,000	23	18.1%
less than \$50,000,000	46	36.2%
less than \$5,000,000	25	19.7%
Grand Total	127	100.0%

### State Governments – all greater than \$1,000,000,000



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### Appendix L: State Government 1099 Reporting Statistics (from ACT Committee Survey)

Type of government entity	Organization use the TIN Matching Program	Sum of 1099-MISC - enter # Issued	Sum of 1099-MISC - enter Total Amount	Sum of CP2100 /CP2100A for form 1099-MISC - # received	Sum of 1099-INT - enter # Issued	Sum of 1099-INT - enter Total Amount	Sum of CP2100 /CP2100A for form 1099-INT - # received
State	No - 7	77,445	\$5,211,300,676.55	2,139	515	\$335,755.90	3
	Yes - 20	312,393	\$44,908,716,686.66	5,690	70,922	\$148,357,367.81	28
Grand Total		389,838	\$50,120,017,363.21	7,829	71,437	\$148,693,123.71	31

Type of government entity	Organization use the TIN Matching Program	Sum of W2G - enter # Issued	Sum of W2G - enter Total Amount	Sum of CP2100 /CP2100A for form W2G - # received	Sum of Other - enter # Issued (applicable forms listed at the end of this survey)	Sum of Other - enter Total Amount (applicable forms listed at the end of this survey)	Sum of CP2100 /CP2100A for Other forms - # received
State	No - 7	-	\$0.00	0	-	\$10,021,297.49	0
	Yes - 20	172,320	\$865,783,881.73	0	54,018	\$1,124,290,624.30	73
Grand Total		172,320	\$865,783,881.73	0	54,018	\$1,134,311,921.79	73

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### Appendix M: Non-State Government Entities 1099 Reporting Statistics (from ACT Committee Survey)

14. Type of government entity - self reported	Sum of 1099-MISC - enter # Issued	Sum of 1099-MISC - enter Total Amount	Sum of 1099-INT - enter # Issued	Sum of 1099-INT - enter Total Amount	Sum of W2G - enter # Issued	Sum of W2G - enter Total Amount	Sum of Other - enter # Issued (applicable forms listed at the end of this survey)	Sum of Other - enter Total Amount (applicable forms listed at the end of this survey)
City	6,183	\$194,611,452.91	10	\$551,453.00	1,130	\$246,314.00	30	\$963,853.99
County	10,796	\$293,581,385.19	1	\$0.00	-	\$0.00	49	\$267,763.73
Federal	4	\$61,119.25	0		-		0	
Town	3,871	\$77,045,817.43	87	\$10,513.51	-	\$0.00	1	\$90.00
Independent Authority	721	\$15,055,765.76	0	\$0.00	75	\$3,500,000.00	9	\$25,000.00
Grand Total	21,575	\$580,355,540.54	98	\$561,966.51	1,205	\$3,746,314.00	89	\$1,256,707.72

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## Appendix N: Non-State Government Entities Demographics (from ACT Committee Survey)

Entity	Spending (non-payroll)	#	1099s Issued	B-Notices	% Return	Average # of 1099s issued
City	\$1,000,000,000 or more	6	662	15	2.27%	110
County	\$1,000,000,000 or more	3	756	16	2.12%	252
Independent Authority	\$1,000,000,000 or more	1	76	4	5.26%	76
Town	\$1,000,000,000 or more	9	655	68	10.38%	73
		19	2,149	103	4.79%	113
City	less than \$1,000,000,000	5	1,493	38	2.55%	299
County	less than \$1,000,000,000	7	6,606	90	1.36%	944
Town	less than \$1,000,000,000	2	452	5	1.11%	226
		14	8,551	133	1.56%	611
City	less than \$100,000,000	11	1,695	103	6.08%	154
County	less than \$100,000,000	4	2,309	37	1.60%	577
Independent Authority	less than \$100,000,000	2	48	8	16.67%	24
Town	less than \$100,000,000	6	944	16	1.69%	157
		23	4,996	164	3.28%	217
City	less than \$50,000,000	20	1,424	26	1.83%	71
County	less than \$50,000,000	5	1,120	28	2.50%	224
Independent Authority	less than \$50,000,000	5	526	8	1.52%	105
Town	less than \$50,000,000	16	1,619	33	2.04%	101
		46	4,689	95	2.03%	102
City	less than \$5,000,000	15	609	6	0.99%	41
County	less than \$5,000,000	1	5	0	0.00%	5
Federal	less than \$5,000,000	1	4	1	25.00%	4
Independent Authority	less than \$5,000,000	1	71	2	2.82%	71
Town	less than \$5,000,000	7	201	0	0.00%	29
		25	890	9	1.01%	36
<b>Grand Total</b>		<b>127</b>	<b>21,275</b>	<b>504</b>	<b>2.37%</b>	<b>168</b>

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**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Indian Tribal Governments:  
Report on the General Welfare Doctrine as Applied to  
Indian Tribal Governments and Their Members**

Wendy Pearson  
Will Micklin  
Holly Easterling

**June 6, 2012**

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## **I. Executive Summary**

This report addresses an ever-increasing and evolving area of controversy between tribes and the Internal Revenue Service (IRS) involving the taxation of benefits provided by tribal governments to their members. The issue is whether payments made by the tribal government to its members under a tribal program designed to promote the general welfare of the tribal citizens is includable in the income of those recipients. The controversy arises commonly in the context of information reporting audits of tribes by the Internal Revenue Service (IRS). This context itself presents a problem for both tribes and the IRS as the audits are, by nature, case by case and resource intensive and do not result in clear guidelines that all tribes may follow to determine the taxability of tribal benefit programs. Further, in most instances, the tribal benefit does not fall within a statutory exemption from taxation, so taxation of the benefit is determined by a rather imprecise administrative rule of exemption called the “General Welfare Doctrine” (GWD) which provides that payments made by federal, state, local, and Indian tribal governments under a legislatively-provided social benefit program for promotion of the general welfare are excludable from gross income.

Complicating the matter even more for benefits paid by tribal governments is the fact that the administrative exemption under the General Welfare Doctrine has evolved largely from rulings related to benefits provided by state and local governments to their citizens. The paradigm of state and local governments and their role and relationship to their citizens does not often provide a meaningful or instructive model in determining whether tribal programs serve the “general welfare” of tribal citizens and, as such, are exempt from taxation. 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. Tribal governments have a very different relationship and role with respect to tribal citizens than state and local governments have to their citizens. Because tribal property (land, resources, and certain tribal funds) is held communally, decisions about allocation of resources are vested in the tribe’s government. And, historically, the tribe’s government is meant to ensure that the resources of the tribe are preserved for the members, that culture and tradition is maintained and fostered, and that the individual needs of the members are met from these resources. Accordingly, tribal benefit programs are as diverse as are the needs of the more than 566 federally recognized tribes and their members. Predictably, most tribal benefit programs do not fit squarely within the contours of a General Welfare Exclusion which has been defined largely by the types of programs a state and local government would customarily provide to its citizens.

For Indian tribal citizens from tribes that conduct gaming activities, another limiting condition for the general welfare exemption is found in Section 11(b)(2)(B) of IGRA which provides that net revenues from tribal gaming must be used for limited purposes, which include (among other things) to provide for the general welfare of the Indian tribe and its

members. 25 U.S.C. 2710 (b)(3)(D), Indian Gaming Regulatory Act (“IGRA”). Uses of the net gaming revenue are set forth by the tribe in a Revenue Allocation Plan that must be approved by the U.S. Secretary of the Interior. Gaming revenues not used for tribal operations and the general welfare of the members, and which are distributed “per capita” to the tribal citizens, are expressly subject to tax as confirmed by IGRA. It is not uncommon for the IRS to assert that all forms of cash or in-kind benefits paid to a tribal citizen constitute a deemed per capita payment of gaming net revenues. This presents a troubling issue for tribes whose allocation of net gaming revenues to the general welfare of the members has already been approved by the Secretary of the Interior, but the IRS proposes to tax these general welfare benefits as if they are instead “per capita” payments.

In response to ongoing concern of tribes that the application of the General Welfare Doctrine to tribal programs lacks clarity, consistency, and certainty, the Department of the Treasury recently sought comments from tribes to discuss the application of the administrative exemption to Indian tribal government programs that provide benefits to tribal citizens. Comments were invited describing actual or proposed programs and how the exclusion applies or should apply to these programs and benefits. Although the comment period ended officially on March 15, 2012, the Department of the Treasury and IRS have indicated that input from the ACT and continuing input from tribes will facilitate future guidance in this area.

Accordingly, the ACT report is meant to advance the conversation between the IRS and tribes and to facilitate future guidance. The ACT acknowledges that this is a significant area of controversy, with many divergent views among tribes and a vast array of different tribal programs among the 566 federally recognized tribes. The ACT report does not purport to represent the views of all the tribes and cannot reasonably encompass all the possible permutations of the issue. Thus, to serve the resolution of this area of controversy, the ACT report will:

- present a statement of the General Welfare Doctrine and its development as well as the history of the relevant tax law and the exclusion’s administration in Indian country;
- describe the tribal perspective on the lack of clarity of the General Welfare Doctrine, present a survey of the comments received in response to Notice 2011-94, and provide a sampling of tribal programs and services that serve the general welfare of the tribal citizens and tribal communities;
- describe the unique role of tribal governments, as well as some of the history and traditions of tribes and their governments in order to make the case for a different administrative exemption rule to apply to tribal benefit programs; and

- make recommendations to:
  - (1) develop a process which permits tribes to take affirmative steps to develop their general welfare programs in a way that will provide either a safe-harbor or rebuttable presumption to shift the burden of proof to the IRS to establish that the particular tribal program has not met the General Welfare Exclusion, e.g., a tribal government may codify its tribal General Welfare Doctrine or approve policies by resolution;
  - (2) modify the IRS approach to “disguised” or “deemed” per capita payments under IGRA; and

[We found the historical record and contemporaneous comments from tribes emphasizing the importance of the traditional and customary tribal practice-of-giving starkly contrasted the lack of an administrative capacity within the Department of the Treasury and the Service that would have enabled an understanding of the significant harm visited upon tribal societies by the indiscriminate denial of a General Welfare Exclusion for tribes. We, therefore, are compelled to exceed our mandate, otherwise limited to a review of and recommendations for changes to tax policy and administration, by offering two additional recommendations. Recommendations are: first -- for the amendment of the Department/Service tribal consultation policy to include specific language requiring prior consultation with federally recognized American Indian and Alaska Native tribes; and second -- for the development of a federal-tribal advisory committee, as well as for the addition of a tribal affairs office. The purpose would be to facilitate federal-tribal discussions and resolve problems before they arise in the field.]

- (3) amend the Department/Service tribal consultation policy; create a Treasury/IRS Secretary’s Tribal Advisory Committee (STAC) which would (among other things) serve as a forum for tribes and Treasury/IRS to discuss issues and proposals for changes to Treasury/IRS regulations, policies and procedures; and establish the position of Undersecretary for Tribal Affairs.

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## II. History of Relevant Tax Law and Tax Administration

### A. Statement of the General Welfare Doctrine

Internal Revenue Code (Code) Section 61 provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Tribal income not otherwise exempt is includable in the gross income of the Indian tribal citizen when distributed or constructively received by them. Rev. Rul. 67-284.<sup>1</sup>

For individual Indians, there are some specific exceptions to taxation. Statutory exclusions include income from the exercise of fishing rights (26 U.S.C. § 7873) and the receipt of per capita distributions of certain funds held in trust by the Office of Special Trustee (BIA) under 25 U.S.C. §§ 1401-1408. A common law exclusion applies to income of an Indian allottee derived directly from his/her trust land. *Squire v. Capoeman*, 351 U.S. 1 (1956). Finally, there may be specific types of income that are exempt by treaty.

Further, it is generally accepted that basic government services are typically excluded from income. These include: education, public safety, court system, social services, public works, health services, housing authority, parks and recreation, cultural resources, and museums. See Technical Advice Memorandum (TAM) 200035007. Where, in lieu of these general services, payments are made by federal, state, local, and Indian governments to individuals and families, a particular administrative exception to the general rule of broad includability of income has developed through IRS rulings and determinations, called the “General Welfare Doctrine” (GWD) or “General Welfare Exclusion” (GWE).

Under the General Welfare Doctrine, payments made by federal, state, local, and Indian tribal governments under a legislatively-provided social benefit program for promotion of the general welfare are excludable from gross income. This is a seemingly broad statement of exclusion for government payments that promote the general welfare of its citizens. However, the IRS has further refined the circumstances to which the doctrine is limited:

When a governmental unit makes payments to or for the benefit of an individual or family, in the absence of a disaster, governmental payments made without regard to financial status, health, educational background, or employment status do not qualify under the General Welfare Exclusion because they are not based on “need.”

See Rev. Rul. 76-131<sup>2</sup>; and Rev. Rul. 85-39.<sup>3</sup>

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<sup>1</sup> 1967-2 C.B. 55.

<sup>2</sup> 1976-1 C.B. 16.

<sup>3</sup> 1985-11 C.B. 21.

Based on this definition, the parameters of the General Welfare Exclusion are as follows:

- 1) the exclusion applies only to individuals or families, not businesses. (See Notice 2003-18);<sup>4</sup>
- 2) the payment must be made from a governmental general welfare fund for a legislatively-provided social benefit program;
- 3) the payment cannot be for services provided by the recipient; and
- 4) the payment must be for the promotion of the “general welfare.”

Rev. Rul. 82-106.<sup>5</sup> The basis of need is determined by financial status, health, educational background or employment status, or on the basis of a disaster.

As we show in this report, establishing the requisite “need” has been a source of contention and confusion for tribal governments, as well as all governments. It is helpful to review some of the historical IRS rulings in this area to ascertain where some of the issues arise and to begin to explore options for resolving them.

## **B. Development of the General Welfare Administrative Exclusion**

The General Welfare Exclusion was first enunciated in the mid-twentieth century. Among the first rulings is Revenue Ruling 57-102 which provided that a state’s assistance payments to blind persons made pursuant to a legislative act were not includable in income.<sup>6</sup> The doctrine was refined further in the mid-1960’s with several rulings that concerned taxability of benefits under work-training programs. Revenue Ruling 63-136 provided that a state’s payments to train unemployed workers under a federal program, including payments for transportation and subsistence in the case of persons whose training was provided in facilities not within commuting distance of their regular place of residence, were excludable from income.<sup>7</sup> However, work training programs for unemployed workers that involved on-the-job training were not excludable, because the payments were considered by the IRS to be tantamount to compensation for services even though the services embodied some degree of training. See Rev. Rul. 65-139;<sup>8</sup> clarified by Rev. Rul. 66-240.<sup>9</sup> Later in 1971, the IRS modified its position again on the issue of payment for services in a work-training context, stating that payments made to welfare recipients in a work-training program would not be includable in income, except to the extent the payments under the work-training

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<sup>4</sup> 2003-1 C.B. 699.

<sup>5</sup> 1982-1 C.B. 16.

<sup>6</sup> 1957-1 C.B.15.

<sup>7</sup> 1963-2 C.B.19.

<sup>8</sup> 1965-1 C.B. 31.

<sup>9</sup> 1966-2 C.B. 19.



program may exceed the amount they would have otherwise received in the form of public welfare benefits. Revenue Ruling 71-245.<sup>10</sup>

Ruling areas evolved outside of work assistance payments to general welfare programs that addressed other types of need. For instance, Revenue Ruling 74-74<sup>11</sup> allowed tax-free reimbursements from the state of New York to crime victims who would suffer “serious financial hardship” due to their loss of earnings and expenses incurred by reason of their injury (i.e., financial need). In Revenue Ruling 74-205,<sup>12</sup> the IRS ruled that replacement housing provided by a government entity to persons displaced by certain federal laws were excludable from income. The payments were specifically made to acquire “decent, safe and sanitary dwellings of modest standards sufficient in size to accommodate the displaced owners, and reasonably accessible to public services and places of employment,” (i.e., not explicitly financial need).

Evolution of the doctrine by category of “need” can be summarized as follows:

**1) alleviating unemployment through direct payments and job training; i.e., “employment status;”**

- Certain payments made to a participant in a program administered and financed by a public agency for the purpose of compensating for or alleviating unemployment have been held to be excludable from gross income, as long as the payment is not for services rendered. For example, Rev. Rul. 70-280<sup>13</sup> holds that payments on account of unemployment paid by a state agency out of funds received from the Federal Unemployment Trust Fund are not includable in the gross income of the recipients.
- Similarly, Rev. Rul. 63-136<sup>14</sup> holds that payments under the Area Redevelopment Act and the Manpower Development and Training Act of 1962 are intended to aid the recipients in their efforts to acquire new skills that will enable them to obtain better employment opportunities. As such, the payments fall in the same category as other unemployment relief payments made for the promotion of the general welfare, and thus, are not includable in the recipients’ gross income.
- On the other hand, if the payments are in the nature of compensation for services rendered, they are included in the gross income of the recipient. Thus, Rev. Rul.

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<sup>10</sup> 1971-2 C.B. 76.

<sup>11</sup> 1974-1 C.B. 18.

<sup>12</sup> 1974-2 C.B. 20.

<sup>13</sup> 1970-1 C.B. 13.

<sup>14</sup> 1963-2 C.B. 19.

65-139,<sup>15</sup> as clarified by Rev. Rul. 66-240,<sup>16</sup> holds that payments made to enrollees in certain work-training programs established under Title 1-B of the Economic Opportunity Act of 1964,<sup>17</sup> are compensation for services and are includable in gross income. That work-training program provided useful work experience opportunities for unemployed men and women between the ages of 16 and 22 through participation in state and community work-training programs, so that their employability could be increased or their education resumed or continued.

- The determination as to whether payments under work-training programs are includable in a participant's gross income rests on whether the activity for which the payments are received is basically the performance of services or is only participation in a training program that promotes the general welfare. If the activity engaged in is basically the performance of services, the payments are compensation for services rendered, and are includable in the gross income of the recipient. Conversely, if the activity amounts only to participation in a training program, the payments are in the nature of relief payments made for the promotion of the general welfare and are excludable from the gross income of the recipient. Rev. Rul. 75-246.<sup>18</sup>
- Rev. Rul. 71-425<sup>19</sup> holds that payments made by a state welfare agency in lieu of (and in amounts no greater than) the normal relief allowance, to participants in work-training programs under Title V of the Economic Opportunity Act of 1964, are not includable in the gross income of the recipient and are not wages for employment tax purposes, since the payments are measured by the personal or family need of the recipient rather than the value of any services performed.

The foregoing rulings identify a few parameters for the exclusion. Foremost is the limitation that the payment cannot be, principally, for services rendered. And, welfare programs directed at alleviating unemployment are specifically countenanced by the General Welfare Exclusion. Finally, the need can be expressed in terms of a household and not just the need of an individual recipient.

## 2) addressing financial need, i.e. “financial status;”

Interestingly, some of the following financial need rulings have articulated a specific measure for determining financial need, while some do not. This leaves some room

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<sup>15</sup> 1965-1 C.B. 31.

<sup>16</sup> 1966-2 C.B. 19.

<sup>17</sup> Pub. L. 88-452, 45 U.S.C. 2701.

<sup>18</sup> 1975-1 C.B. 24.

<sup>19</sup> 1971-2 C.B. 76.

for subjectivity in determining the requisite level of financial need. In that regard, the requisite financial need is not necessarily the lowest denominator, such as poverty level, but can be measured according to median income levels.

- Rev. Rul. 74-153<sup>20</sup> addresses payments made by a state to adoptive parents who use the payments for support and maintenance of their adoptive child. Payments may be made for any child in the local department's foster care program upon the placement of that child in an adoptive home that meets all other eligibility tests as an adoptive home except for the ability to provide financially for an adoptive child. The amount and duration of the payments are based upon a written agreement between the adoptive parents and the local Department of Social Services. The payments are disbursed from foster care funds at a maximum rate of three-fourths of the foster care rate for board and clothing.

Note, in the above ruling, the level of financial "need" is not defined as low-income or otherwise. The purpose of the payments were to further "the social welfare objectives of the state." The IRS did not require a specific showing that each recipient met some defined level of financial need.

- Rev. Rul. 74-205<sup>21</sup> held that a community development program providing relocation payments and assistance for displaced individuals and families, as authorized under the Housing and Urban Development Act of 1968, and the Uniform Relocation Assistance and Real Property Acquisitions Policies Act of 1970, were excluded as GW payments. These payments were provided in addition to the replacement acquisition costs and as a condition of receiving the additional assistance payments, a displaced owner only had to purchase and occupy a replacement dwelling within one year of receiving the payments. The purpose of the 1968 Act was to further implement the national goal of providing "a decent home and a suitable living environment for every American family."
- Rev. Rul. 75-271.<sup>22</sup> Mortgage assistance payments in the form of interest subsidies under the National Housing Act. Interest subsidy amounts are determined by HUD based on a showing of "need," which is measured by the family household income.

In the above ruling, need is measured not by the individual, but by family household needs.

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<sup>20</sup> 1974-1 C.B. 20.

<sup>21</sup> 1974-2 C.B. 20.

<sup>22</sup> 1975-2 C.B. 23.

- Rev. Rul. 76-373<sup>23</sup> addresses relocation costs paid to families displaced by urban renewal project under the Housing and Community Development Act of 1974. The primary objective of the Act was “the development of viable urban communities, by providing decent housing and a suitable living environment and expanding economic opportunities, principally for persons of low and moderate income.”

Development of viable communities and economic opportunities is the defining purpose for the foregoing General Welfare Exclusion, with only moderate financial need as the measure.

- Rev. Rul. 76-395.<sup>24</sup> Home rehabilitation grants, under the same Housing and Community Development Act of 1974, were made by a city to families whose annual income did not exceed \$5,000.
- Rev. Rul. 78-170<sup>25</sup> excludes utility assistance payments made by Ohio to low-income (total annual income of less than \$7,000) elderly or disabled residents.

### 3) **education assistance payments, i.e., “educational background;”**

There have been only a few private letter rulings specifically applying the General Welfare Doctrine to exclude educational assistance, probably because 26 U.S.C. § 117 may otherwise exempt the education benefits. Barring an exclusion under Code Section 117, the following rulings establish that education assistance payments may serve a general welfare purpose, without regard to a showing of individual financial need.

- Private Letter Ruling (PLR) 8725052. The Department of Agriculture provided education assistance payments to members of a family whose farm or ranch has been terminated or in financial crisis. Eligibility was based on financial need and directed only to farm families.
- Technical Advice Memorandum (TAM) 200035007.<sup>26</sup> Education benefits provided by a tribe in the form of pre-school, tutoring, secondary educations assistance for learning disabled and a summer youth program. In that case, direct distributions were not made to the member. The education program was administered without regard to financial need. The IRS concluded the tribe was providing a basic government service of educating its members.

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<sup>23</sup> 1976-2 C.B. 16.

<sup>24</sup> 1976-2 C.B. 16.

<sup>25</sup> 1978-1 C.B. 24.

<sup>26</sup> 2000 TNT 172-13.

- PLR 200409033. This ruling involved a tribal education program. The program provided educational benefits in the form of books, supplies, transportation, tuition, room and board, and day care. There were two classes of recipients of these educational benefits: members whose income was at or below the national family median income level and those whose income may be greater than the median. The IRS ruled that the benefits paid to the lower-income members whose income was below the median constitute general welfare payments, while the members above that level could not exclude the education benefits from income unless the benefits otherwise qualified under 26 U.S.C. 117. Notably, the requisite showing of financial need was not “poverty,” but a median income level.

#### **4) special needs related to “health;” and**

There are few rulings for this area of “need.” However, these rulings point toward a more subjective measure, and seeming flexibility, in the application of the General Welfare Exclusion. In one, the state’s judgment as to what would be considered sufficient financial hardship was not upset by the IRS. In the other, implicit in the ruling is a determination that there is a public benefit in providing care to persons whose life circumstances or conditions warrant special assistance, tax-free. A showing of financial need under those circumstances is not necessary to excluding the benefit from income under the General Welfare Doctrine. These concepts are important to evaluating the General Welfare Doctrine as applied to tribes. That is, the judgment of the tribal government in determining the requisite level of financial need for its member benefits should be respected by the IRS much like the deference given in Rev. Rul. 74-74 below. Further, there are numerous conditions and circumstances afflicting tribes and their members that warrant special assistance, and financial need is not the only such need.

- Rev. Rul. 57-102.<sup>27</sup> This is one of the first exclusion rulings under the General Welfare Doctrine. The IRS found that a legislative program provided benefits to blind persons was a social welfare program whose benefits would not be included in the income of the recipients.
- Rev. Rul. 74-74.<sup>28</sup> Under a special program for crime victims, New York state provided support to those victims who suffered out-of-pocket losses or loss of work by reason of personal physical injury inflicted during a crime. The award was limited to \$100/week, or \$15,000 in aggregate, and was payable only to crime victims who would otherwise suffer “serious financial hardship” without the

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<sup>27</sup> 1957-1 C.B. 26.

<sup>28</sup> 1974-1 C.B. 18.

award. The level of demonstrable financial hardship was not defined, and the award left to the judgment of a board appointed by the state. These awards were excluded from income by the IRS because they were in the “interests of the general public,” citing Rev. Rul. 63-136.

#### 5) **disaster relief.**

Governmental payments to help individuals and families meet disaster-related expenses were initially evaluated for exclusion under the General Welfare Doctrine. Since 2002, there has been a statutory basis for excluding disaster relief payments under 26 U.S.C. § 139. The General Welfare Exclusion still may apply for payments outside the ambit Code Section 139. In this context of disaster relief, the general welfare rulings again contemplate a broader view of need beyond financial. Some of the pertinent rulings on General Welfare Exclusion provide as follows:

- Rev. Rul. 76-144.<sup>29</sup> This ruling holds that grants made under the Disaster Relief Act of 1974 to help individuals or families affected by a disaster meet extraordinary disaster-related necessary expenses or serious needs in the categories of medical, dental, housing, personal property, transportation, or funeral expenses (and not in the categories of nonessential, decorative, or luxury items) are excluded from gross income under the General Welfare Exclusion. In this context, because “need” is not defined in terms of financial need, the General Welfare Exclusion applies equally to all residents of an affected area regardless of their income levels. See also Rev. Rul. 2003-12<sup>30</sup> (payments for unreimbursed reasonable and necessary medical, temporary housing, and transportation expenses incurred as a result of a Presidentially-declared disaster).
- Rev. Rul. 98-19.<sup>31</sup> Relocation payments made to an individual moving from a flood damaged area are not includable in income. Payments were made pursuant to the 1997 Emergency Supplemental Appropriations Act for Recovery from Natural Disasters (Supplemental Act).
- Chief Counsel Advice (CCA) 200022050. Payments from the state to assist low-income homeowners in replacing, repairing, or rehabilitating their flood-damaged homes are not includable in the homeowners’ gross incomes.

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<sup>29</sup> 1976-1 C.B. 17.

<sup>30</sup> 2003-1 C.B. 283.

<sup>31</sup> 1998-1 C.B. 840.

### C. Judicial Acceptance of the General Welfare Exclusion

Courts have had very little to say on the subject of the General Welfare Exclusion. The Tax Court has reviewed cases for a General Welfare Exclusion only a few times. In *Bailey v. Commissioner*, 88 T.C. 1293, 1299-1301 (1987), the court held that a facade grant, paid to a building owner as part of an urban renewal initiative, was not based on a showing of need and, therefore, was not excluded under general welfare exception (although the grant was excludable from income under a different test). The court relied on many of the above-cited IRS rulings in support of its determination that the General Welfare Exclusion requires a showing of some type of “need.”

In *Graff v. Commissioner*, 74 T.C. 743 (1980), affd. per curiam 673 F.2d 784 (5th Cir. 1982), the issue involved the National Housing Act, which provides that qualifying sponsors of low-income housing projects are entitled to interest reduction payments by the federal government on mortgage loans taken to acquire the housing. The interest reduction payments enabled the sponsor to charge lower rents to the tenants. Thus, the tenant was intended to be the ultimate beneficiary of the interest reduction payments, and the benefit received by him is, in the nature of welfare, not taxable to him. 74 T.C. at 753-754. However, the interest payments to the sponsors were subject to tax.

In *Bannon v. Commissioner*, 99 T.C. 59 (1992), the court confirmed that payments made under a state of California welfare program to provide in-home supportive service to its disabled citizens are not income to those recipients. However, the disabled person may choose to hire support services with those funds, and the service provider is subject to tax on any of the funds paid to him or her. 99 T.C. at 63. Only the persons intended as the “ultimate beneficiaries” of the government subsidy can be said to have received a welfare benefit excludable from tax. *Id* (citing *Graff*). See also *Harper v. Commissioner*, T.C. Summary Opinion, 2011-56.

The Supreme Court has not addressed this tax exclusion doctrine directly, but has nodded to it. Referring to a New York state low-income housing subsidy, the Supreme Court acknowledged the doctrine in dicta in a case in which the ultimate question did not involve the presence of taxable income under the Code, but instead involved the possibility of profits under the securities laws: “In a real sense, it no more embodies the attributes of income or profits than do welfare benefits, food stamps, or other government subsidies.” *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 855 (1975). This ruling acknowledges that payments based on financial need are tantamount to government welfare payments and, as such, do not constitute income to the recipient.

## **D. Administration of the General Welfare Exclusion in Indian Country**

### **1. Audits of Tribal General Welfare Benefit Programs**

The issue as to whether certain payments made by a tribal government to its members are excludable under the General Welfare Doctrine arises commonly in the context of an information return audit of the tribal government. 26 U.S.C. § 6041(a) and § 1.6041-1(a)(1)(i) of the Income Tax Regulations provide, with some exceptions, that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income, aggregating \$600 or more in the taxable year, must file an information return with the Internal Revenue Service. By Code Section 6041(d), the payor is required to furnish an information statement to the payee. Treas. Reg. § 1.6041-1(d)(2) (payor reports on Forms 1096 and 1099). The Code Section 6041 information reporting requirement applies to payments made also by governments. Accordingly, unless an exclusion from income applies under the General Welfare Doctrine (or some other statutory or common law exclusion), the IRS will find that distributions from tribal governments to their members are subject to the requirements of filing Forms 1099 (assuming the \$600 aggregate threshold was met).

A distribution to members could derive from many revenue sources, such as:

- a. distributions of profits from Class II and Class III gaming activities (“per capita” payments);
- b. profits from a tribal business other than a Class II or Class III gaming operation;
- c. interest income on investments;
- d. rental payments from improvements on tribal lands; and
- e. revenue sharing programs.

In addition to information reporting, the IRS may also audit the tribal government for its compliance with Form 945 reporting, which relates generally to withholding requirements under 26 U.S.C. 3402(r) on per capita distributions of profits from Class II and Class III gaming activities. Under the Indian Gaming Regulatory Act (IGRA), net revenues from any Class II or Class III gaming activities conducted or licensed by an Indian tribe may be used to make per capita<sup>32</sup> payments to members of the tribe. 25 U.S.C. § 2710(b)(3)(D). One of

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<sup>32</sup> The IGRA guidelines define “per capita” payments as those payments made or distributed to all members of the tribe or to identified groups of members which are paid directly from the net revenues of any gaming activity. 25 CFR, Ch. 1, Part 290.



the four conditions for making such distributions is for the tribe to notify the recipient that the per capita is subject to federal tax and to withhold such tax when certain thresholds are met. *Id.*

The Internal Revenue Manual (IRM) at Chapter 4.88.1 is devoted to audits of Indian Tribal Governments. In this section of the IRM, the IRS describes how the agent should determine whether disbursements to members are exempt under the General Welfare Doctrine. The pertinent part of the IRM provides:

(3) Per capita payments do not include benefits for special purposes or programs, such as social welfare, medical assistance, or education. Although a tribal citizen may receive benefits from net revenue for social welfare, medical assistance, or education, the tribe's designation of these payments is not determinative of their tax status.

(4) Under the General Welfare Doctrine, certain need-based benefits are not taxable. Although there is no express statutory exclusion for a welfare benefit, government disbursements promoting the general welfare of the tribe are not taxable. Thus, a tribal citizen may receive non-taxable general welfare payments from the tribe. *Bannon v. Commissioner*, 99 T.C. 59 (1992); *Bailey v. Commissioner*, 88 T.C. 1293 (1987). See also Rev. Rul. 2005-46, Rev. Rul. 2005-2 C.B.120 (Payments to individuals by governmental units under legislatively-provided social benefit programs for the promotion of the general welfare are excluded from gross income under the General Welfare Exclusion).

(5) To qualify under the General Welfare Exclusion, payments must:

- a. be made from a governmental fund;
- b. be for the promotion of the general welfare (i.e., generally based on individual or family needs); and
- c. not represent compensation for services.

(6) .... A key consideration is that the General Welfare Doctrine requires an individual to establish need.

#### **IRM 4.88.1.7.1.**

This last point in the IRM, requiring a showing of individual need, appears contrary to a number of General Welfare Exclusion rulings previously cited. The General Welfare Exclusion permits tax-free benefits upon a showing of need for a family household, not each individual who may receive the general welfare benefits in that household. See, *e.g.*, Rev. Rul. 75-251.

## 2. IRS Rulings on Tribal General Welfare Programs

There is a paucity of rulings concerning the General Welfare Exclusion for tribal government welfare programs. The first ruling, involving Indian tribes and their members, was Revenue Ruling 57-233<sup>33</sup> holding that grants made by the United States to members of tribes for training and education are considered non-taxable gifts. A decade later, in Revenue Ruling 68-38,<sup>34</sup> the IRS approved, as non-taxable, payments to tribal citizens under a job-training program pursuant to state and federal programs; the program was considered effectively equivalent to the type of program approved in Rev. Rul. 63-136, as a general welfare payment.

Nearly fifteen years later, the IRS issued Rev. Rul. 77-77.<sup>35</sup> The ruling involved a grant program where individual Indians of various tribes received non-reimbursable grants under the Indian Financing Act of 1974, Pub. L. No. 93-262 (the “Act”). Title IV of the Act, entitled *Indian Business Grants*, was established by Congress for the purpose of stimulating and increasing Indian entrepreneurship and employment by providing equity capital through non-reimbursable grants made by the Secretary of the Interior to Indians and Indian tribes to expand profit-making, Indian-owned, economic enterprises on or near reservations. In determining the grants were excluded from income, the IRS relied on its previous rulings at Rev. Rul. 74-205<sup>36</sup> and Rev. Rul. 75-271<sup>37</sup> relating to mortgage assistance payments made on behalf of low-income homeowners under the National Housing Act. The ruling acknowledges a general and overall economic need of Indian tribes to expand economic activity on or near the reservation. This is an important acknowledgment that can and should be sufficient predicate for many tribal general welfare programs, beyond even the context of business grants.

In addition, the special circumstances relating to the trust status of tribal property can also serve as a rational basis for exempting tribal general welfare benefits. For instance, the IRS ruled that a business grant program designed by an Indian tribal government to stimulate the creation of reservation-based business enterprises was an exempt general welfare program. PLR 199924026 (March 19, 1999). In that case, a tribe made loans to fund start-up businesses by members because they could not receive traditional commercial loans. The IRS concluded that there was a proven need to subsidize startup businesses due to lack of third-party funding and, thus, the tribal grants were exempt from member income. This particular tribal reservation suffered high unemployment rates and lack of access to capital, which were factors supporting the conclusion that the payments were excludable under the General

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<sup>33</sup> 1957-1 C.B. 60.

<sup>34</sup> 1968-1 C.B. 446.

<sup>35</sup> 1977-1 C.B. 11.

<sup>36</sup> 1974-1 C.B. 20.

<sup>37</sup> 1975-2 C.B. 23.

Welfare Doctrine. Similarly, in PLR 200336030, the IRS addressed a tribal housing assistance program that was modeled after the federal HUD program. The program gave priority to elderly tribal citizens, emergency situations involving health or safety hazards, and applicants with children. HUD-type programs essentially operate as an interest subsidy; and housing assistance, in the form of interest-free loans, can qualify as grants if based on financial need. Citing, Rev. Rul. 76-395.<sup>38</sup> Among the needs identified was the lack of conventional home financing for new construction because of limitations on creditor's rights and remedies on Indian trust lands. Both of these rulings identify circumstances unique to tribes, not the least of which is a pervasive need for economic development throughout Indian country and lack of access to capital. Yet, as discussed below, we see little acknowledgment of these special needs when the IRS reviews particular tribal general welfare programs to determine whether they are exempt from income.

As noted previously, educational assistance from tribes is the subject of some of the more recent IRS rulings. TAM 200035007 addresses tribal education programs administered without regard to financial need. The IRS acknowledged the tribe was providing a basic government service of educating its members and the benefits were, therefore, not includable in the recipient's income. In seeming contradiction to its 2000 ruling, the IRS ruled in a private letter ruling in 2004 that educational assistance payments from tribally chartered corporation for qualifying tribe members, with an income below the national family median income level, qualified for exclusion under the General Welfare Doctrine, but members whose income was above that level were required to include the education assistance payment in their gross income (unless the benefits otherwise qualified for exclusion from income under Code Section 117). PLR 200409033.

Other later rulings address certain housing assistance payments from tribes. In one such program, a tribe addressed the problem with a substantial number of its members who lived in inadequate or substandard housing. PLR 200336030 (Jun. 6, 2003). The tribe developed a housing assistance program modeled after HUD programs. The tribal housing benefits consisted primarily of loans in amounts up to \$80,000, 75% of which could be forgiven. This program qualified as a nontaxable general welfare program. See also, PLR 200632005 (tribe's housing grant program provided healthy, safe, habitable housing that could not be adequately met through other means). These are programs directed at lower income families and individuals, but also address a tribal government's interest in developing viable reservation communities by providing decent housing and a suitable living environment. The latter purpose is not measured exclusively on the basis of an individual's financial means.

As the above ruling suggests, it is a legitimate government purpose to promote a healthy living environment and sustainable *communities*. General welfare programs, which address

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<sup>38</sup> 1976-2 C.B. 16.

community needs, have been acknowledged by the IRS to be exempt from taxation. See, *e.g.*, Rev. Rul. 75-271. Likewise, Congress appears to acknowledge that it is within the province of a tribal government to determine what community needs are essential. The Essential Families statute 25 U.S.C. 4131(b)(3) provides that a tribe may determine “the presence of the family on the Indian reservation ... *is essential* to the well-being of Indian families...” 24 C.F.R. § 1000.110(f) provides the income eligibility requirements “do not apply to non-low-income Indian families *which the [tribe] has determined to be essential* to the well-being of the Indian families residing in the housing area.” [emphasis added] The only criterion stated is that of “reasonableness” in that “...the need for housing for the family cannot reasonably be met without such assistance.” The Exception to Low-Income Requirement statute 25 U.S.C. 4131(b)(2)(A) only requires “...a need for housing for those [over income] families that cannot reasonably be met without that assistance” as the standard for approval. (Note: this statute is cited for illustrative purposes only and has not, as yet, been promulgated as regulation and is currently unavailable to tribes).

### **3. IRS Rulings Do Not Provide Clear Guidance**

The above-cited private letter rulings provide little guidance to tribes for the simple and sufficient reason they are non-precedential and limited only to the facts of those cases. From a tax policy and tax administration concern, this results in lack of “fair notice” of IRS positions. Moreover, the rulings articulate, seemingly, conflicting views of the General Welfare Doctrine — for instance: a view that endorses a financial-needs test (*e.g.*, PLR 200409033) versus a view that endorses a broader application of general welfare services that a government may provide regardless of financial need (TAM 200035007, Rev. Rul. 57-102); or, a view that requires a showing of individual need (IRM 4.88.1.7.1) versus a view that allows need to be measured on an aggregate showing for the family household. (Rev. Rul. 75-251.)

Another complicating factor lies in the fact that the General Welfare Doctrine has evolved largely from rulings that address state and local government programs, not tribal programs. Not infrequently, tribal programs differ significantly from those customarily provided by state and local governments. Thus, existing state and local government rulings do not apply neatly to tribal programs. For the many reasons enumerated below, with respect to tribal culture and history, tribal governments establish many programs that are not based upon individual income. Programs to preserve tribal traditions, for example, must be made available to all tribal citizens and have little if anything to do with individual income. Tribal programs to promote self-determination, economic development, and employment on reservation, such as the business grant program approved in Revenue Ruling 77-77 and Private Letter Ruling 199924026, are based on community needs rather than on individual income.

Another problem lies in the fact that the tribes receive unequal treatment in the application of the General Welfare Exclusion. That is, the audit outcomes among tribes can vary significantly depending on the type of general welfare program under scrutiny, the representative involved, the IRS agent involved, and so on. Not uncommonly, there are varying interpretations by the IRS agents, from case to case, as to the requisite showing of “need,” with many interpretations narrowing to require a showing of individual financial need. Clearly, the General Welfare Exclusion is not so narrow, but more to the point, the interpretations do not consider the unique circumstances of the tribe and the particular general welfare needs being addressed by a particular tribal program.

Disparate and uncertain application of the General Welfare Exclusion is, of course, unacceptable to both the IRS and the tribes as it undermines effective tax administration and the ability of a tribe to manage its internal affairs.

#### **4. Special Problems Concerning Application of the General Welfare Exclusion to Gaming Tribes**

Code Section 3402(r) adds a complicating feature to audits of tribal governments that is not present in audits of state and local governments. As it relates to their respective general welfare programs, tribes with gaming operations appear to receive different treatment than states with lottery operations. Under the Indian Gaming Regulatory Act (“IGRA”), gaming revenues not used for tribal operations and the general welfare of the members, and which are distributed “per capita” to the tribal citizens, are expressly subject to tax. 26 U.S.C. § 3402(r) and 25 U.S.C. § 2710 (b)(3)(D). Code Section 3402(r) imposes a federal withholding tax obligation on “any person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenue of any Class II or Class III gaming activity conducted or licensed by the tribe.” There is no corollary to this statute for a state’s use of lottery revenues for the benefit of its citizens.

Pursuant to Section 2710(b)(3) of the IGRA, an Indian tribe may use net revenues from gaming to make per capita payments to members of the Indian tribe, but only if the following requirements are met:

- (A) the Indian tribe has prepared a plan to allocate revenues to authorized governmental or charitable uses;
- (B) the plan is approved by the BIA as adequate, particularly with respect to funding of tribal governmental operations and programs and promotion of tribal economic development;
- (C) the interests of minors and other legally incompetent persons who are entitled to receive any of the per capita payments are protected and preserved; and

- (D) the per capita payments are subject to federal taxation; and the tribes notify members of such tax liability when payments are made.

See 25 U.S.C. § 2710(b)(3).

Some tribes choose not to make per capita payments. For those that do make per capita payments, the IRS regularly asserts that purported “general welfare” distributions in cash or in-kind to a tribe’s members constitute disguised or deemed “per capita” payments under IGRA. As such, the IRS asserts that the distribution is subject to tax withholding under Code Section 3402(r) if a general welfare exemption does not clearly apply.

This appears to be a distortion of IGRA’s intent. Although the statutory language of Code Section 3402(r) does not explicitly limit its reach to per capita distributions of net gaming revenue, the context of the provision’s enactment suggests that it was intended to apply only to such payments and not to amounts paid to tribal citizens through governmental benefit programs. The Senate Finance Committee described, then current, the law governing the payment of per capita payments as follows:

Net revenues from certain gaming activities conducted or licensed by an Indian tribe may be used to make taxable distributions to members of the Indian tribe. The tribe must notify its members of the tax liability at the time the payments are made. 25 U.S.C. 2710(b)(3) and (d)(1). The tribe is not required to withhold on such payments except to the extent backup withholding rules apply under Code Section 3406.

S. Rep. No. 412, 103rd Cong., 2nd Sess. (1994). See also H. Rep. No. 826, Part 1, 103rd Cong. 2d Sess. (1994), reprinted in 1995-1 C.B. 250. While neither the Internal Revenue Code nor the legislative history of Code Section 3402(r) defines the term “taxable distribution,” the Service’s broad interpretation of Code Section 3402(r) results in unequal treatment among tribes (gaming and non-gaming tribes, or per capita and non-per capita tribes) and between tribal governments and state governments.

### III. Statement of the Issue from the Tribe's Perspective

Because the general welfare exception is an administrative exemption that has evolved largely from rulings related mostly to benefits provided by state and local governments, tribal governments have not been given sufficient notice of Treasury's position on the taxability of tribal programs. As noted above, gaming tribes have historically relied upon IGRA to address taxability of payments sourced by net gaming revenues. While IGRA confirms that per capita payments are clearly subject to federal taxation and reporting to members, the other authorized uses of net gaming revenues carry inherently non-tax related purposes and characteristics: (i) to fund tribal government operations or programs; (ii) to provide for the general welfare of the Indian tribe and its members; (iii) to promote tribal economic development; (iv) to donate to charitable organizations; or (v) to help fund operations of local government agencies.

Tribal representatives trying to educate themselves elsewhere on the issue will find inconsistency in the tax treatment of tribal programs, not only in various rulings described in the previous pages, but also within informal guidance publications and webinars sponsored by the Indian Tribal Governments (ITG) division of the Internal Revenue Service. For instance, an August 2011 webinar, entitled "Do's and Don'ts: Reporting Requirements for Indian Tribal Governments," resulted in the assurance that per capita distributions do **not** include programs such as social welfare, medical assistance, or education (slide #45). However, recent audits have revealed that tribal programs (social welfare, medical assistance and education), without a showing of individual financial need, were deemed "disguised" per capita distributions and found to have new Form 1099 reporting requirements and sometimes back-up withholding, depending upon the source of program funding. Also within ITG's published "Native American Issues: Income Tax Primer" (current publication dated February 2008), under the heading "**Distributions**," [taxable] per capita distributions are distinguished from general welfare payments stating, "General Welfare Distributions are payments which have been set aside by the tribe for special purposes or programs, such as payments made for social welfare, medical assistance, education, housing, or other similar specifically identified needs." The primer goes on to state that it is critical that the need be based on financial, economic, health, educational, **or** other similar criteria that support the determination that the payment is assistance to address the identified "need" and that the individual must provide the information to support whether the payment fits the necessary criteria. In addition, the IRS ITG website Q&As provide such basic "easy case" examples -- that it can give the impression that the doctrine is narrower than the law may actually allow. Outside inconsistent Revenue rulings, Tax Advice Memorandums, Private Letter Rulings, and informal guidance publications, tribal governments have no clarity on application of the General Welfare Exclusion to Indian tribal government programs.

## **A. Survey of Tribal Comments to Treasury**

In response to many inquiries from Indian tribal governments on this issue, and in order to provide clarity and certainty to Indian tribal governments and consistency in applying the exclusion, the Service and Treasury (pursuant to E.O. 13175) issued Notice 2011-94 on November 15, 2011, to invite comments describing actual or proposed Indian tribal government programs that provide benefits to members, and the application of the exclusion to these programs and benefits. Although the comment period officially ended March 15, 2012, input from tribal governments continues to be considered, as of this date.

The ACT would like to present some of the over-arching themes and consistencies in the comments which have been received to date in the hopes that any guidance issued will acknowledge and reflect tribal perspective and concerns. The replies, to date, from various tribes and tribal organizations to Treasury, can be summarized as follows:

- IRS/Treasury should be held accountable to Executive Order 13175 which provides direction to federal agencies on agency rulemaking.
  - Tribes request respect for Indian self-government and sovereignty and, where possible, deference to standards to which preserve the prerogatives and authority of Indian tribes as directed by the President.
  - Tribes request that the IRS/Treasury work with Indian tribes on a government-to-government basis, and recognize the federal government's unique obligation to tribes. Greater training of IRS employees on tribal governments is also requested.
- The U.S. is a party to the United Nations Declaration on the Rights of Indigenous Peoples which recognizes that indigenous peoples have important collective human rights which necessitate special measures by the government to protect and preserve those rights.
  - Federal policies should, thus, encourage the preservation of tribal culture in accordance with the UNDRIP, not tax and punish tribal citizens actively participating in the preservation of their traditions and practices.
- Acknowledge that IGRA mandates the provision of tribal programs and services as an aspect of self-government prior to taxable per capita payment to individual tribal citizens.
  - Also, that federally approved revenue allocation plans (RAP) in accordance with IGRA should be respected. Per capita reclassification, by IRS, violates IGRA RAP designations.



- Payments or services under a bona fide social benefit program are not per capita payments even if the benefits are provided on a community-wide or tribal-wide basis.
- Audits of Indian tribes are discriminatory on the basis that the same audits are not being conducted on state and local governments or foreign nations.
  - IRS agents should not substitute personal judgment for decisions that are made pursuant to a political process and form of government recognized by treaties, Congressional acts, and Presidential Executive Orders spanning more than a century of tribal-federal relations.
  - While General Welfare Exclusion guidance is being developed, interim relief from the inconsistent application of the exclusion to Indian tribes under audit or subject to other enforcement actions should be provided.
- Tribal self-government traditionally includes housing assistance, education, child and elder care, and cultural preservation.
- The federal government should foster, not punish or interfere with, the provision of programs that address the unmet unique treaty and legal obligations.
- Tribal education services should never be subject to taxation by the United States because of the historical solemn promises made and unfulfilled and because tribal education policies always equate to general welfare.
- Individual means-testing violates tribal culture and tradition and lack of means-testing should not disqualify a tribal program from the exclusion when other eligibility criteria are present.
  - “Need” is not just financial, and includes matters of health, educational background, employment status, and others.
  - “Need” can be community based, such as high unemployment rates, lack of access to capital, or disproportionate poverty levels.
  - “Need” can be cultural, such as programs that restore, protect, promote, and extend tribal cultural heritage.
  - “Need” can be justified by programs that supplement or supplant federal funding or work towards the same goals of federal policy (even in the absence of federal funding).

- “Social benefit” rather than “individual need” should be the primary focus, with deference to each tribal government in setting social goals and establishing programs to achieve them. Social benefit must encompass self-determination and be construed broadly to reflect unique cultural and traditional-based programs and economic development.
- Too much focus has been placed on individual means-testing, and too little on the overall social benefit a program seeks to achieve.
- Guidance must be broad and give substantial deference to the discretion of tribal governments and their legislative policy making process.
  - Each tribe has its own checks and balances in place for the approval of programs, and those processes should be given deference.
  - Tribal governments contain appropriate accountability mechanisms that are based on tribal community values, reciprocal responsibilities, and programmatic objectives.
  - Tribes can identify shortcomings or abuse with an immediacy that federal agents will never attain.
  - Tribal governments should be acknowledged as partners in the tax compliance process and not as adversaries.
- Benefits received pursuant to cultural programs should not constitute compensation for services when governmental assistance is tied to community service or job training programs.

## **B. Summary of Common Tribal Welfare Programs**

In response to the request for descriptions of actual or proposed Indian tribal government programs, below are descriptions of some tribal programs which were compiled from the responses to the Notice, as well as additional surveys completed by the ACT. These are presented for illustrative purposes only and not intended to be exhaustive or exclusive.

- **EDUCATION PROGRAMS** – Tribal education programs are often enacted to address systemic, community-wide, gaps in achievement, as well as to promote and encourage scholastic pursuit by helping students overcome barriers to education. Programs outside those which are excludable under Code Section 117 may include transportation assistance, clothing assistance, musical instrument rental assistance, incentive programs for good grades and achievement, school-to-work programs, assistance with graduation expenses, etc.

- **TRANSPORTATION ASSISTANCE** – Transportation needs are critical for many remote Indian reservations and for tribal citizens, in general. Assistance with transportation may include auto repair grants, as well as public transportation for access to employment locations, tribal facilities, and health and education facilities.
- **HOUSING PROGRAMS** – Tribal housing assistance programs normally address overall community needs, such as health and safety, energy efficiency, and so on, by helping citizens to attain home ownership or improve existing living conditions. Typical housing programs include repair programs, loan assistance, construction assistance, elder or disabled member improvements, storm shelters, temporary shelter or hotel reimbursement programs, and other housing related assistance.
- **EMERGENCY ASSISTANCE** – This can come in many forms including assistance to prevent utility cut-offs or eviction, situations of unexpected loss, or being stranded and in need of a hotel room and/or meals.
- **BEREAVEMENT AND BURIAL ASSISTANCE PROGRAMS** – Tribal governments offer these services as a direct means of preserving culture and tradition and to promote family unity and honor to the family. Wakes, family obligations, food, and assistance are unique to each tribe.
- **CULTURAL PROGRAMS** – Maintaining and revitalizing culture and traditions is of paramount importance to each Indian tribe and is integral to the United States' government-to-government relationship with tribal governments. Cultural programs range from language classes to art classes, to pow-wows and other ceremonies, and to funding historical/cultural travel events. Although churches are not sovereign governments, churches' activities that promote religious principles are insulated from tax liability; and, similarly, when a tribe provides for the exercise of culture, the cultural enrichment, or the cultural restoration of its members, those benefits should be exempt from taxation, as well.
- **ELDER PROGRAMS** – Tribal elder programs recognize traditional or cultural obligations to elders that have no counterpart in non-tribal programs or even among different tribes. Tribal priorities in honoring elders should be respected much the same as government-provided Medicare benefits which further social welfare objectives. Elder programs can include meals, social events, home improvement and maintenance, cultural travel, and utility assistance.
- **ECONOMIC DEVELOPMENT PROGRAMS** – These are generally based on community needs that Indian tribes enact to address the unique economic problems on Indian reservations and to promote economic diversification and job creation for tribal

citizens. Programs could be job training programs, business grants, and other programs that are consistent with community goals.

Tribes overwhelmingly offered thanks to Treasury and the Service for requesting official comments through the Notice process and for giving them an opportunity to provide input on this most important issue. Tribal programs and economies are directly affected by the taxation of tribal citizen benefit programs; and tribes have not been given clear guidance on the issue. Inconsistent and conflicting informal guidance and rulings; the need for Treasury and IRS to gain a better understanding of tribal governments and their inherent authority; and the necessity of giving new consideration to the function of tribal programs are all justifiable reasons for a comprehensive joint effort between Treasury and tribal governments to resolve this tax issue.

#### **IV. The Case for Modification of the General Welfare Exclusion as Applied to Indians**

To resolve the General Welfare Exclusion issue, it may be appropriate to develop a general welfare exemption that applies specifically to tribal governments and their individual members. The U.S. has committed to protecting tribes as separate sovereigns. One expression of that commitment is the rule that federal laws should not be interpreted to invade upon a tribe's internal affairs – i.e., in this instance, its determination of general welfare needs of its members. Naturally, when the IRS asserts that a tribal government's distribution of cash or in-kind benefits is not made to promote general welfare of its members, this is perceived as a federal intrusion into the internal affairs of a sovereign tribe. On the other hand, the IRS is tasked with enforcing the federal tax laws, which entails seemingly intrusive audits to determine the form and substance of a transaction for tax purposes. Accordingly, there is cause to develop an administrative tax exemption that takes into account the unique circumstances of tribes and their sovereign authority over internal affairs, while at the same time promoting effective tax administration.

This is an area of tax law that has seen meteoric rise in controversy between the IRS and tribes in the last few decades. Some say, until the advent of IGRA in the late 1980's, there was little revenue in Indian country to warrant much IRS scrutiny, and, significantly, there was never a vehicle to leverage a tribe to withhold tax on any perceived distribution of wealth until Code Section 3402(r). Whether those facts have any bearing, it is undisputed that audits of tribal governments and their enterprises have increased. And, the General Welfare Exclusion is playing a more prominent role in these audits as tribes develop more programs.

It is in the best interests of both the tribes and the IRS to seek a more cost-efficient and predictable means of testing tribal general welfare programs for tax exemption. Tribes require a predictable test or safe harbor for establishing their programs to maximize tax exemption and tax-favored opportunities. The case-by-case audit process to tease out key features that a tribe may later rely upon to establish a tax exempt general welfare program is both inefficient and unfair. Likewise, the IRS can better accomplish its twin goals of efficient tax administration and procedural fairness if there were more certain guidelines in establishing a tax exemption under the General Welfare Doctrine.

There are over 560 federally recognized tribes. Each have unique "needs" to address for their members and, to that end, unique tribally-sponsored general welfare programs tailored to those needs. It is impossible for the ACT to propose a solution that represents the divergent views of all the tribes, or encompasses the sheer diversity and magnitude of this issue across Indian country. More importantly, this is a matter for tribes and the federal government to

work out through consultation. Executive Order 13175.<sup>39</sup> Nevertheless, by this report, the ACT endeavors to provide some recommendations that may serve to advance resolution of this issue between the IRS and the tribes.

**A. The General Welfare Exclusion Should Not Undermine a Tribe's Inherent Power to Regulate its Internal and Social Relations**

There will be at least a couple avenues toward resolution of this issue in Indian country. One may involve a tribe establishing its own written General Welfare Doctrine and policy through governmental action. The other may involve the development of another IRS administrative exemption, through consultation between tribes and Treasury, which is specific to tribes - a "Tribal General Welfare Doctrine" - if you will. Either way, a tribe's inherent sovereignty over the internal affairs and social welfare of its members must be part of the calculus when IRS and Treasury set out to determine the tax-exempt nature of benefits received under a tribal welfare program. Part of the solution will also involve an understanding of the "community need" as determined by tribal governments replacing the individual means-testing applied in most audits, to date.

Accordingly, any fair application of the General Welfare Exclusion to tribes can only be accomplished with a thorough understanding and appreciation of tribal customs and the inherent sovereign authority of tribal governments over internal and social relations. The ACT explores some fundamentals to inform the analysis.

**1. Retained, Inherent Tribal Sovereignty**

Tribes are sovereign governments, and are not non-profit corporations, ethnic groups with entitlements granted by Congress, fraternal associations, religious organizations, or other entities lacking inherent governmental powers. Too often, discussion of the tribal general welfare exception associates tribal governments with dissimilar entities that lack the unique standing of tribes as the first of the three sovereigns, preceding in time the federal and various state governments.

Tribes are among the four sovereigns recognized by the United States Constitution, which are foreign countries, the federal government, states, and tribes. The Constitution and subsequent legal doctrine recognizes the *inherent* (rather than delegated) powers possessed by tribes that pre-date the United States. Indian governmental powers inherent to tribal governments cannot be limited only to a Congressional or Constitutional delegation of

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<sup>39</sup> Federal Register / Vol. 75, No. 132 / Monday, July 12, 2010 / Notices.

powers,<sup>40</sup> but are also defined by historical, traditional, and customary understanding of Indian people themselves.<sup>41</sup>

In what is known as the “Marshall trilogy,” the Supreme Court established the doctrinal basis for interpreting federal Indian law and defining tribal sovereignty:

1. *Johnson v. McIntosh* (21 U.S. 543 (1823)): the tribes’ power to dispose of their land required Congressional consent;
2. *Cherokee Nation v. Georgia* (30 U.S. 1 (1831)): Indian tribes were merely “domestic dependent nations” existing “in a state of pupilage, and their relation to the United States resembles that of a ward to his guardian;” and
3. *Worcester v. Georgia* (31 U.S. 515 (1832)): the states are excluded from exercising their regulatory or taxing jurisdiction in Indian country.

The Marshall trilogy developed three bedrock principles: (1) by virtue of aboriginal political and territorial status, Indian tribes possessed certain incidents of preexisting sovereignty; (2) such sovereignty was subject to diminution or elimination by the United States, but not by the individual states; and (3) the tribes’ limited inherent sovereignty and their corresponding dependency on the United States for protection imposed on the latter a trust responsibility.<sup>42</sup> These principles have continued to guide Courts in their interpretation of the respective rights of the federal government, the states, and the tribes.

Tribal governmental powers may be viewed as limited by Congressional divestiture of, or limitations upon, certain tribal government powers through federal Indian law, United States Supreme Court decisions, federal jurisprudence, and Congressional legislation.<sup>43</sup> The concept of “domestic dependent nations,”<sup>44</sup> or “quasi-sovereignty” that limits tribal control only to internal relations without the express consent of the United States Congress was set forth in the 2001 United States Supreme Court decision, *Nevada v. Hicks*, that held, “[the] exercise of tribal power beyond what is necessary to protect tribal self-government or to control internal relations is inconsistent with the dependent status of tribes, and so cannot survive without

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<sup>40</sup> Indian Tribes as Sovereign Governments (Oakland, CA: AIRI Press, 1998), at 35.

<sup>41</sup> See Wallace Coffey & Rebecca Tsosie, *Rethinking the Tribal Sovereignty Doctrine: Cultural Sovereignty and the Collective Future of Indian Nations*, 12 STAN. L. & POL’Y REV. 191, 196 (2001) (“Our Ancestors recognized themselves as distinctive cultural and political groups, and that was the basis of their sovereign authority to reach agreements with each other, with the European sovereigns, and then the United States. In each of these instances, our Ancestors exercised governmental authority to protect their lands, resources, peoples and cultures.”)

<sup>42</sup> American Indian Law Deskbook, University Press of Colorado, 1993.

<sup>43</sup> Indian Tribes as Sovereign Governments, op. cit.; Canby, William C., Jr., American Indian Law in a Nutshell (St. Paul, MN: West Publishing Company, 1988); and Strickland, Rennard, Felix S. Cohen’s Handbook of American Indian Law (Charlottesville, VA: Mitchie Bobbs-Merrill, 1982).

<sup>44</sup> *Cherokee Nation v. Georgia*, 30 U.S. 1, 17 (1831).

express congressional delegation.”<sup>45</sup> In *United States v. Wheeler* <sup>46</sup> the Supreme Court stated, “Although physically within the territory of the United States and subject to ultimate federal control, they nonetheless remain “a separate people, ***with the power of regulating their internal and social relations.***” (emphasis added). The Supreme Court in *Talton v. Mayes* said that Indians tribes’ inherent sovereignty predates the Constitution.<sup>47</sup> The Supreme Court decided that, because tribal power originates from the tribe’s inherent sovereignty, the tribe did not have to follow the U.S. Constitution’s rule for grand juries.

Under these principals of an inherent authority over their own internal affairs, such authority would necessarily include protecting and promoting the social welfare of a tribe’s members. Thus, a General Welfare Exclusion tailored specifically to an acknowledgement of this role and authority is “necessary to protect tribal self-government.”

## **2. Right of Self-Determination**

Consistent with, and in addition to, the sovereignty of tribal governments, is the United Nations’ statement and support of the right of self-determination for indigenous peoples. The United Nations Declaration of the Rights of Indigenous Peoples (UNDRIP) recognizes the collective and individual rights of native peoples. Among the most important of these rights is the right of self-determination, stated as follows:

Article 3. Indigenous peoples have the right to self-determination. By virtue of that right, they freely determine their political status and freely pursue their economic, social, and cultural development.

Article 4. Indigenous peoples, in exercising their right to self-determination, have the right to autonomy or self-government in matters relating to their internal and local affairs, as well as ways and means for financing their autonomous functions.

The Declaration also recognizes the following rights:

- rights to control membership and institutions (Articles 5, 20);
- spiritual and religious rights, including sacred sites (Article 12); and
- rights to maintain a subsistence lifestyle and traditional economic activities (Article 20).

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<sup>45</sup> 533 U.S. 353, 359 (2001) (emphasis removed) (quoting *Montana v. United States*, 450 U.S. 544, 564 (1981)).

<sup>46</sup> 98 S.Ct. 1079, 55 L.Ed.2<sup>nd</sup> 303, 435 U.S. 313.

<sup>47</sup> 163 U.S. 376 (1896).



The Declaration specifically calls for the maintenance and protection of native cultures and identities, and the full and effective participation of Native peoples in all matters that concern them. On 16 December 2010, President Obama declared that the United States is going to sign the declaration. At the second White House Tribal Nations Conference, on December 16 of 2011, President Barack Obama announced that the U.S. would “lend its support” to UNDRIP. “The aspirations it affirms, including the respect for the institutions and rich cultures of Native peoples, are ones we must always seek to fulfill,” Obama said. “I want to be clear: What matters far more than words, what matters far more than any resolution or declaration, are actions to match those words.”<sup>48</sup>

IRS support for a General Welfare Exclusion for tribal payments that address community need, and recognition of the cultural, economic, and governmental importance of this traditional and customary practice, would be a significant action to “match the words” of UNDRIP and the U.S. fulfillment of its principles.

## **B. A Tribal Definition of Need Is Warranted**

To define the tribal standard for “need” contemplated by a tribal General Welfare Exclusion, the historical, traditional, and customary practices of tribes (as they relate to property transfers, giving, and the role of tribal leaders in the care of tribal citizens) must inform the analysis. It is incumbent upon Treasury and the IRS to understand these aspects of tribal culture, which, although different from state and local governments in application, are nonetheless the customary role of a government to satisfy the needs of its citizens. Thus, any rigid comparison of a tribal welfare program to a state and local general welfare program would distort the analysis and outcome.

Perhaps an apt analog to where we stand today in addressing the effects of an uninformed application of the General Welfare Exclusion is the history and genesis of the Canadian Potlatch law. The Potlatch law banned “any Indian festival, dance, or other ceremony” involving the “giving away or paying or giving back” of property.” In 1923, Andrew Paull of the Allied Tribes of British Columbia argued against Canada’s Potlatch law. Paull wrote, “what has been said in favor of the Potlatch has been done so by the people who are in a position to know, but the prayer of the Indians has not heretofore been given due consideration.”<sup>49</sup> In the same way, the view of tribal governments has not been given due consideration in the IRS application of the General Welfare Exclusion. The IRS and Treasury should seek to align their perception of tribes’ general welfare payments with its actual origin and purpose. To date, the IRS (mis)perception of tribal government payments in cash

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<sup>48</sup> Indian Country Today Media Network.com, UN Declaration’s One-Year Anniversary: “Much to Celebrate, Much More to Be Done”, <http://indiancountrytodaymedianetwork.com/2011/12/12/un-declaration%E2%80%99s-one-year-anniversary-much-to-celebrate-much-more-to-be-done-66108>, December 12, 2011, By Gale Courtney Toensing.

<sup>49</sup> The Potlatch Papers, Christopher Bracken, University of Chicago Press, 1997, p. 227.

or property, to its tribal citizens, bears little to no resemblance to the actual historical, traditional, and customary practice of tribes. As some have said, the IRS perception is a substitute for the tribes' practice, and not an image of it.<sup>50</sup> This is because, in large part, the IRS either ignores or misapprehends the tribal culture that comprises the tribal practice.

A more in-depth inquiry is warranted: What is this system of tribal payments? What is the significance of these payments to tribal society? What is the relation between the payment, the tribal government as giver, and the tribal citizen as recipient in the context of tribal culture and the inherent, retained sovereign authority of tribal governments to regulate their internal social relations?<sup>51</sup> These are precisely the questions that should be asked, answered, and understood prior to formulation of an IRS policy on the General Welfare Exclusion as applied to tribal welfare programs.

### **1. Historical, Traditional, and Customary Practices Focus on Community Need**

History shows that ownership of goods was not an accumulation of individual wealth, but rather such ownership must be understood in the context of a tribal economy that valued giving, among all members of the community, through a system of payments among community citizens. Wealth was neither hoarded nor equally distributed. Rather, those with skills and social standing, sufficient to accumulate property, provided a portion of their property to others as an amount of quality goods through participation in community giveaways. In this process, honor was received when bestowing property on others in the community; and honor was received when receiving such property. Marcel Maus describes the Tlingit and Haida Potlatch system, wherein Maus states that “[n]o less important is the role which honor plays in the transactions of the Indians. Nowhere else is the prestige of an individual as closely bound up with expenditure, and with the duty of returning, with interest, gifts received in such a way that the creditor becomes the debtor. . . . Progress up the social ladder is made in this way not only for oneself but also for one's family.”<sup>52</sup> Through giving, and in giving property in a pre-monetary society, the individual and their clan and sib relations, earn honor and community standing by the giving and receipt of property. By this system of payments mediated by clans and sibs, honor was exchanged, tribal leadership positions were acquired, and community need was satisfied without shaming those in need.

The labeling of these transactions as gifts and giving is more a reflection of the Western culture that interprets the Indian culture, but is a poor representation of the rich and complex structure of this system. In fact “[t]he integrity of the community as a whole depends upon

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<sup>50</sup> Ibid, p. 227-228.

<sup>51</sup> Ibid, p. 23.

<sup>52</sup> The Gift: Forms and Functions of Exchange in Archaic Societies 35-36 (1967).

this exchange of [property]. The underlying philosophy of the tribal community permeated the ways of commerce, a sense of interdependence between all of the families forming clans and kinship groups as the foundation for the larger tribal organization.”<sup>53</sup> While the giving is not particularized to a distribution to the needy, these transactions served this purpose as an ancillary outcome that benefitted the less wealthy and obviated the need for donations to those in need that otherwise would have dishonored the recipients as well as their clan and sib affiliations.

Among tribes, the system of giving is a bonding experience. Giving “bonds one to the group and within the group, because the individual provides gifts that allow the group to prosper, and the group provides gifts that allow the individual to prosper. Giving is a way of building new relationships, while maintaining and reinforcing old ones. The circle-of-life belief system is one of interconnections, or inter-relationships, where the key value is one of recognizing the reciprocal nature of relationships.”<sup>54</sup>

From the early days of contact with Europeans, the record is replete with the generosity extended by tribal nations to Europeans, and extends to the modern record of the familial care that tribal nations extended to each other and to those invited into the tribal community as guests. The commercial relations formerly sought with tribal nations by representatives of European nations traveling through the ancient trade routes depended on the establishment of values of kinship affected by the tribal social behavior of giving. An example of this is illustrated in an account of Comanche society from this time period.<sup>55</sup>

Comanches responded positively to demonstrations of social behavior like that involved in gift giving. American traders, unfamiliar with the ways of Indians, quickly learned the positive effects of providing their hosts with gifts. In this way, persons without any kinship or other social connections to the Comanches could begin to establish such ties through which commerce could be conducted. The European traders were not bribing Indians or buying franchises for access to commercial opportunity, but instead participating in the essential social structure of the Indian society and, by doing so, becoming an equal eligible for respect, honor, and equality.<sup>56</sup>

Tribal historians and commentators have provided insight into these values. Charles Alexander Eastman, Ohiyesa, explained the view of tribal property exchange in this way:

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<sup>53</sup> Angelique A. EagleWoman/Wambdi A. Wastewin, Tribal Values of Taxation Within the Tribal Economic Theory, *Kansas Journal of Law & Public Policy* [Vol. XVIII:1], p. 4.

<sup>54</sup> Mindy Berry, “Native American Philanthropy,” in *Cultures of Caring*, 49; and Ronald Austin Wells, *The Honor of Giving: Philanthropy in Native America* (Indianapolis: Indiana University Center on Philanthropy, 1998).

<sup>55</sup> *Ibid.*, p. 5.

<sup>56</sup> Gerald Betty, *Comanche Society: Before the Reservation*, 116 (2002).

“[I]t has always been our belief that the love of possessions is a weakness to be overcome. Its appeal is to the material part, and if allowed its way it will in time disturb the spiritual balance for which we all strive.”<sup>57</sup>

Eastman spoke from the Dakota tradition as a core value of tribal society. Royal Hassrick in “The Sioux: Life and Customs of a Warrior Society” states:

“[A] precept of the Sioux was stated frequently by the tribesmen: ‘A man must help others as much as possible, no matter whom, by giving him horses, food or clothing.’ Generosity was a virtue upon which Sioux society insisted. To accumulate property for its own sake was disgraceful, while to be unable to acquire wealth was merely pitiable. The ownership of things was important only as a means of giving, and blessed was the man who had much to give. The Sioux pattern further required not only that a proffered gift might not be refused but that a return gift, even though a token, should sometime be exchanged.”<sup>58</sup>

Angelique EagleWoman in “Tribal Values of Taxation Within the Tribal Economic Theory” explains the “congruence between tribal values and the basic concept of taxation.”<sup>59</sup> The American Heritage Dictionary of the English Language (2006) definition of “tax” is “a contribution for the support of a government required of persons, groups or businesses within the domain of that government.”<sup>60</sup> Eaglewoman’s view is that the “concept of interdependence envelops the basic concept of taxation – a recognition that for the tribal government to provide services, contributions are expected from those skilled within the community. Informally, contributions are made among tribal citizens on a daily basis along kinship, clan and family lines. Those who are employed are expected to contribute when requested on an individual basis for necessities of other community members.” The exchange of property among tribal citizens through the regulation of clan and sib social structures was, therefore, a form of taxation for the equitable re-allocation of essentials among the community members. This system of payments or property exchange regulated the societal or community need.

The historical and contemporary record clearly evidences that tribes’ customary and traditional practice of giving to address the **COMMUNITY** need is integral to the culture and necessary to protect, preserve, and regulate their social relations. Tribal society employed

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<sup>57</sup> Charles Alexander Eastman (Ohiyesa), *The Soul of an Indian and Other Writings* 26 (Kent Nerburn ed., 2001) (“Therefore, we must early learn the beauty of generosity. . . . Public giving is a part of every important ceremony. It properly belongs to the celebration of birth, marriage, and death, and is observed whenever it is desired to do special honor to any person or event. . . . Upon such occasions it is common to literally give away all that one has to relatives, to guests of another tribe or clan, but above all to the poor and the aged, from whom we can hope for no return.”).

<sup>58</sup> Royal B. Hassrick, *The Sioux: Life and Customs of a Warrior Society* 36 (1964).

<sup>59</sup> Angelique A. Eaglewoman, *Id.*, p. 16.

<sup>60</sup> The American Heritage Dictionary of the English Language (4th ed. 2006), available at <http://dictionary.reference.com/browse/tax>.

this system of property exchange among all tribal citizens as a means to provide for the community need. There are many forms of giving in Native American culture, often called the Native American philosophy of giving,<sup>61</sup> which evidences this system of payments as a traditional and customary practice. In this way, tribal society provided for the less fortunate without the shame inherent in giving only to the needy individual, and elevated talented individuals to positions of leadership. The community need was satisfied while both giver and recipient gained honor in the exchange. In a modern interpretation, this practice formed an economy of property exchange that was a means of taxation upon the prosperous, and a means of distribution to the needy. The practice of satisfying the community need provided essential property to all; established tribal leaders; and -- as an overall outcome -- preserved, protected, and regulated the society.

Unlike European American values, “wealth” in Native American culture is not measured by net worth, but rather by a combination of spiritual qualities, material goods, and behavior. Leaders are selected for their ability to take care of the tribe by sharing their wisdom and wealth.<sup>62</sup> By highly rewarding equitable (not equal) giving or exchange, tribal leaders rose to prominence by frequently bestowing the necessities of life upon the needy. Thus, all members of society were necessary for balance to be maintained and to distinguish those who would lead.

These values were embraced by all Tribal Nations from coast to coast as fundamental to balance in native society.<sup>63</sup> In a 1987 dissertation by Jean Alice Maxwell, the value of sharing among households of Colville and Spokane tribal citizens along the West Coast were analyzed.<sup>64</sup> The research led to the conclusion that “by holding and observing these values, Colville and Spokane make a statement about who they are; and, as they themselves say among Indian people, who you are is more important than what you have.”<sup>65</sup>

In his work on traditional American Indian economic policy, Ronald Trosper has characterized the four central components of this economic policy as community, connectedness, regard for the seventh generation, and humility.<sup>66</sup> The tribal value of community is understood as an economic policy with the values of fairness, connectedness, and interdependence in a community relationship that carries with it responsibility for the needs of the entire community. A regard for the seventh generation necessarily involves the concept of stewardship and protection of resources for those yet to be born. Finally, humility

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<sup>61</sup> Millett and Orosz 2002.

<sup>62</sup> Ibid.

<sup>63</sup> See Mauss, *supra* note 7, at 32-37; see also Hassrick, *supra* note 78, at 35-36..

<sup>64</sup> Jean Alice Maxwell, *The Circle of Sharing Among Colville and Spokane Indians* (1987) (unpublished Ph.D. dissertation, University of Michigan).

<sup>65</sup> *Id.* at 398-99.

<sup>66</sup> Ronald L. Trosper, *Contemporary Native American Political Issues* 140 (Troy R. Johnson, ed., 1999).

embodies the awareness that if humans do not act appropriately, the natural world is powerful and may retaliate.<sup>67</sup>

These four principles are useful in synthesizing tribal values operative in commercial relations. As stated earlier, the historic tribal economic system was based upon moderation – with neither large wealth accumulation nor equal distribution of all goods. Tribal Nations are neither communistic socialists nor early capitalists.

Ricardo Millett<sup>68</sup> states “Native communities view giving as a way to honor future generations and clan members ... which exemplifies the Native American philosophy that giving should be mutual and equal by all parties. Giving is viewed as equals giving to equals, rather than the rich giving to the poor.”<sup>69</sup> The practice satisfies the community needs, which are: first—to preserve the community fabric by bestowing honor on giver and receiver (equals giving to equals); second—to allocate property of kinds and amounts appropriate to the culture, with the twin outcomes that community members in need are provided for and tribal leaders are identified. Through this traditional and customary practice, the tribal culture was preserved through giving; and tribal leaders were selected for their ability to take care of the tribe by sharing.

## **2. The Historic and Continuing Role of Tribal Leaders Is to Meet Community Need**

In less than 100 years, traditional forms of tribal government changed to a western style form of government. Nevertheless, the tribal system of exchange, whether the historical propertied exchange or the modern payments in cash or property, continue to exhibit the attributes of the traditional and customary practice of satisfying community need in order to both regulate and preserve the internal society and culture of tribes.

The inherent tribal governmental authority to promulgate and implement policy intended to serve the community need of its tribal citizens, by regulating the social relations integral to the health and welfare of tribal society, is to modern tribal governments as it was to historical, traditional tribes. Historical tribes were controlled by clans and sibs. Today’s tribes are modern western-style tribal governments. Tribal governments of every period have employed the practice of satisfying the community need to mediate the adverse effect of contact with non-Indian people and governments.

Since contact, the degradation of tribal economies and resulting impoverishment of tribal societies and their citizens have been, and are today, mediated by tribal leadership. Tribal

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<sup>67</sup> *Id.*

<sup>68</sup> Ricardo Millett, Understanding Giving Patterns in Communities of Color, Fund Raising Management, Vol. 32, Issue 6, p. 25, August 1, 2001.

<sup>69</sup> *Ibid*, p. 26.

societal leadership has been forced to change from clans and sibs to the modern form of IRA-style (Indian Reorganization Act) tribal governments.

Congress intended the Indian Reorganization Act of 1934 (IRA)<sup>70</sup> to resurrect tribal culture and traditions lost to the Indian General Allotment Act of 1887, known as the “Dawes Act,” which broke up tribal lands and allotted them to individual members of tribes. Federal policy under the Dawes Act sought to assimilate and acculturate tribal citizens as individuals into the dominant society. Tribal lands were traditionally held and used for the community need. The Dawes Act resulted in the diminishment of tribal lands from 138 million acres in 1887 to 48 million acres by 1934. The sale of unallotted lands as surplus and the liability of allotted lands to taxation resulted in the loss of more than two-thirds of tribally-held lands by 1934.

This loss of tribal lands destroyed both the tribal economy and traditional tribal government on the reservations.<sup>71</sup> The IRA pressed for tribes to adopt standard constitutions based on the European-American conception of government. Tribes were compelled to adopt governments that tribal people, especially the elders and other traditional American Indians, did not support. Other tribes adopted governments because they were promised by supporters of the legislation that passage would help to end the massive hunger, poverty, and loss of land on American Indian reservations.<sup>72</sup>

The significance of this forced change in governance for tribes cannot be understated. IRA tribal constitutions and bylaws were templates of a European-American version of governance strange to traditional American Indian ways. There was no longer a place for elders, spiritual leaders, and clan and sib leaders in tribal government due to cookie-cutter IRA tribal constitutions.

In spite of the wrenching changes wrought by the IRA, traditional tribal leadership survived through the traditional tribal practices of property exchange that served the community need, which includes: the need to identify and elevate tribal leaders; the need to allocate essential property to the needy; and the need to strengthen the community through the system of honor and mutual respect. This system of community need preserved tribes and their cultures during the most stressful years immediately following the imposition of the IRA when a number of tribal IRA-style governments were not accepted by their tribal citizens. Modern tribal IRA-style governments thrive but only in the context of traditional community leadership that flourishes in the traditions and culture of practices. Indian values, culture, and traditions are not found in tribal constitutions, but tribal leaders depend upon their ancient practice to satisfy community needs in order to validate IRA governmental systems.

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<sup>70</sup> P.L. 73-383.

<sup>71</sup> Casey, James A. Sovereignty by Sufferance: The Illusion of Indian Tribal Sovereignty, 79 Cornell Law Review 404, 413 (1994).

<sup>72</sup> Getches, Wilkinson, and Williams, Jr. (1993), “within 12 years, 161 tribal constitutions and 131 Indian corporate charters had been adopted by tribes pursuant to the IRA” (p. 221).

### **3. Tribes Face Extraordinary Challenges in Meeting the Needs of Their Citizens**

Both the giving practices and needs of tribes have been challenged by their relationship to the United States government and the social, political, and economic changes wrought in the periods known as the reservation era, the New Deal, termination, and, today, self-determination.

The Indian Reorganization Act of 1934 ended the allotment policies, however, the intended recovery of tribal lands for tribes was not realized. Also, the imposition of IRA-style governments restructured traditional tribal leadership away from traditional clan and sib leadership to a western form of governance that sorely stressed tribal societies.

The good intentions of the IRA period were thwarted by the termination policies during the 1950's when Congress sought to terminate the historical relation between the federal government and Indian tribes.<sup>73</sup> Many Indian tribes suffered the loss of tribal status as federally recognized tribes, and all of tribes, suffered from a significant diminishment of federal trust services. The federal government also relocated many thousands of tribal citizens from their tribal communities to urban centers (e.g., San Francisco, Los Angeles, Denver, Minneapolis, etc.).<sup>74</sup>

For Native Americans, removal and assimilation were both policies designed to give the federal government the unilateral power to extinguish a tribe and its citizens. Many who were subject to termination and relocation suffered a terrible loss of tribal connection and cultural identity in addition to impoverishment in foreign urban areas.

There exists a prevailing public view that the Indian Gaming Regulatory Act ("IGRA") provided prosperity for a majority of tribes. This is not true even among the overwhelming majority of tribes that operate tribal government gaming facilities. The record of continuing, significantly unmet tribal community need is evidenced by recent 2010 United State Census data and other credible data sources.

According to the 2010 Census, 5.2 million people in the United States identified as American Indian and Alaska Native, either alone or in combination with one or more other races. Out

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<sup>73</sup> See generally, Native American Rights Fund, Twenty-Fifth Anniversary Report, p. 7. In 1954, Congress passed a resolution to terminate the historical trust relationship between the U.S. government and Indian tribes. Federal funding for all existing service programs to tribes were to end and Indians were to be considered a disadvantaged minority group. Tribes were no longer to be recognized as governmental units. The termination policy was in effect until the mid-1960s.

<sup>74</sup> See generally, Sharon O'Brien, *American Indian Governments*, Norman, OK: University of Oklahoma Press, 1989, p. 86. In 1956, Congress passed Public Law 959, which would use economic incentives to promote assimilation and urbanization in Indian country. It provided funds for institutional and on-the-job training for Indians. It did not, however, make these opportunities available on the reservations. Indians had to relocate to urban areas. Once they were living in the urban areas, Indians were no longer eligible for federal services. More than 35,000 individuals relocated to urban or off-reservation areas.



of this total, 2.9 million people identified as American Indian and Alaska Native alone. Almost half of the American Indian and Alaska Native population, or 2.3 million people, reported being American Indian and Alaska Native in combination with one or more other races. The American Indian and Alaska Native in combination population experienced rapid growth, increasing by 39% since 2000.<sup>75</sup>

The percentage of the American Indian and Alaska Native population, alone or in combination, which lived in American Indian areas or Alaska Native Village Statistical Areas was 22%. These American Indian areas include federal American Indian reservations and/or off-reservation trust lands, Oklahoma tribal statistical areas, tribal designated statistical areas, state American Indian reservations, and state designated American Indian statistical areas.<sup>76</sup>

Counties on Native American reservations are among the poorest in the country and, according to the Economic Research Service at the U.S. Department of Agriculture, nearly 60% of all Native Americans who live outside of metropolitan areas inhabit persistently poor counties.<sup>77</sup>

The median income of American Indian and Alaska Native households was \$35,062. This compares with \$50,046 for the nation as a whole. The percent of American Indians and Alaska Natives that were in poverty in 2010 was 28.4%. For the nation as a whole, the corresponding rate was 15.3%. The poverty rate for American Indians living on reservations (31.2%) is nearly three times the national rate. On some reservations unemployment levels have reached 85%. Overall, the unemployment rate on reservations is over two times the national average. Over 22% of American Indians do not have enough food to meet their basic needs.

The percentage of American Indians and Alaska Natives 25 and older who had at least a high school diploma, GED, or alternative credential was 77%. Also, 13% obtained a bachelor's degree or higher. In comparison, the overall population had 86% with a high school diploma and 28% with a bachelor's degree or higher.

One in five homes on reservations lack complete plumbing facilities and less than 50% are connected to the public sewer system. This has led to the creation of numerous health and environmental hazards. Sixteen percent of reservation households have no telephone service. Only 33% of roads in Indian Country are paved and 72% are officially rated as poor. It is

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<sup>75</sup> American Indians By the Numbers, <http://www.factmonster.com/spot/aihmccensus1.html>

<sup>76</sup> Walking Shield, Inc., [www.WalkingShield.org](http://www.WalkingShield.org), The Need: American Indian Socioeconomic, Housing, Health and Education Statistics, [http://www.walkingshield.org/the\\_need.shtml](http://www.walkingshield.org/the_need.shtml).

<sup>77</sup> Tom Rogers, Native American Poverty, Spotlight on Poverty & Opportunity, <http://www.spotlightonpoverty.org/ExclusiveCommentary.aspx?id=0fe5c04e-fdbf-4718-980c-0373ba823da7>.

estimated that 1.1 billion dollars is needed to adequately address housing inadequacies on American Indian reservations.

Over 90,000 American Indian families are homeless or under housed. Homelessness on reservations is becoming increasingly more visible as families are living in cars, tents, abandoned buildings or storage sheds. Over 30% of American Indian families live in overcrowded housing, and 18% are severely overcrowded with 25-30 individuals sharing a single home. These rates are more than six times the national average. Approximately 40% of housing on reservations is inadequate according to the federal definition, compared to only 6% nationwide. American Indians have the highest rate of home loan denial of any race in the United States; nearly 25%.

According to the U.S. Commission of Civil Rights in 2004 (*“Broken Promises: Evaluating the Native American Health Care System,”* September 2004, The U.S. Commission on Civil Rights, pp. 7, 13), American Indians are:

- 770% more likely to die from alcoholism;
- 650% more likely to die from tuberculosis;
- 420% more likely to die from diabetes;
- 280% more likely to die from accidents;
- 190% more likely to die from suicide; and
- 52% more likely to die from pneumonia and influenza.

According to this study, American Indians also experience:

- a life expectancy a full five years under any other ethnicity in the United States;
- per capita funding for healthcare at 60% less than all other Americans and 50% less than federal prisoners; and
- the highest prevalence of Type 2 diabetes in the world. Treating diabetes for only those Native Americans who are currently diagnosed with diabetes would amount to \$1.46 billion per year, or 40% of the total budget for Native Americans health care.

According to the Indian Health Service in 2006:

- American Indian health facilities have an average vacancy rate of about 13% for all professional health positions. This ranges from a 5% vacancy rate for sanitarians to a 29% vacancy rate for dentists;

- over 79% of American Indian children 2-5 years of age have a history of tooth decay; and
- in total, there is a \$900 million backlog in unmet needs for American Indian health facilities.

Unfortunately, the socio-economic disparities faced by American Indians translate into deficient educational opportunities. The following is the disheartening reality of educational attainment for American Indians today:

- according to the National Education Association, American Indian students in California have a high school graduation rate of just 52%;
- the U.S. Department of Education's 2006 Nation's Report Card on U.S. history found that while White, Black, and Hispanic students all showed improvements on their scores since the last report in 1994, American Indian students showed no sign of improvement;
- in 2005, the California Postsecondary Education Commission found that eligibility rates for American Indian high school seniors were only 19.7% for a California State school compared to 34.3% for Whites. Further, only 6.6% of American Indian high school seniors met the University of California eligibility requirements compared to 16.6% of White students;
- according to a 2010 study<sup>78</sup> by the Civil Rights Project/Proyecto Derechos Civiles at UCLA's Graduate School of Education and Information Studies (GSE&IS) conducted in 12 states,<sup>79</sup> overall non-Native student graduation rates in the 12 states included in this study ranged from 54.1% to 79.2%, with an average of 71.4%. In contrast, graduation rates for American Indian and Alaska Native students ranged from 30.4% to 63.8%, with an average of 46.6%. The graduation rates for all American Indian and Alaska Native students were lower than the overall state rates, and with the exception of Oklahoma and New Mexico, the degree of disparity was approximately 17 percentage points or more. On average, the report found that graduation rates for American Indians and Alaska Natives (46.6%) were lower than the graduation rates for all other racial/ethnic groups including Whites (69.8%), Asians (77.9%), Blacks (54.7%), and Hispanics (50.8%); and
- according to the 2003 National Adult Literacy Survey, 32% of American Indian adults failed to attain basic reading levels, compared to only 13% of White adults.

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<sup>78</sup> The Dropout/Graduation Crisis Among American Indians and Alaska Native Students; Failure to Respond Places the Future of Native People at Risk, <http://civilrightsproject.ucla.edu>.

<sup>79</sup> Alaska, California, Idaho, Montana, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Washington, and Wyoming.

Even among the more prosperous gaming tribes, a single generation of prosperity is woefully insufficient to address the significant harm wrought upon the culture, society, and governance of all tribes, in addition to the significant financial needs of the overwhelming majority of all tribes. Nor should economic advancement by tribes and their tribal citizens, which is the goal if not the effect of federal Indian policy, become a rationale to further erode tribal culture. The policy of genocide, followed by the now discredited policy of assimilation and then termination that sought to influence or compel tribal citizens to give up their traditional cultural practices, caused incalculable harm. The long list above should be sufficient reason to protect the traditional and customary tribal practices that tribal governments employ in response to its community need.

Thus, it is uncontroverted that there is a pervasive, unmet need in Indian country for economic development, job creation, education, and other key infrastructural components that will support viable communities and decent living. See also *Indian Tribal Governments: Report on the Implementation of Tribal Economic Development Bonds Under the American Recovery and Reinvestment Act of 2009*, June 2010 (“ACT Report of Recommendations, 2010”). Accordingly, tribes must be given the ability to meet those needs, particularly since the federal government has not met its trust obligations in those areas of need. *Id.*

However, the IRS typically targets tribal practices/programs intended to address these unmet needs by denying the application of the General Welfare Exclusion to such payments. The General Welfare Exclusion by definition contemplates that a government will develop programs targeted at particular conditions or circumstances afflicting their citizens for which some governmental subsidy is necessary to serve the general welfare of the citizenry. And, in that regard, such a general welfare subsidy does not embody “the attributes of income or profits.” *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 855 (1975). As to what support is necessary and reasonably calculated to meet the particular need is rightfully within the province of that government to decide and should not be readily undermined by a narrow application of the General Welfare Exclusion. There is considerable room within the articulated parameters of the General Welfare Exclusion to give deference to the tribal government to meet “social welfare objectives” (e.g., Rev. Rul. 74-153); to provide “a decent home and a suitable living environment” (e.g., Rev. Rul. 74-205); or provide benefits which “expand economic opportunities” (e.g., Rev. Rul. 76-373).

But, to date, the manner in which the General Welfare Exclusion has been applied to tribal welfare programs is obstructing the ability of tribal leaders to raise the abject condition of their citizen Indians. The continuing challenges to tribes and their tribal citizens that result in a large unmet community need persist in Indian country. The General Welfare Exclusion should support and foster non-taxable tribal practices and programs that satisfy the community need, not hinder them.

## V. ACT Recommendations

### A. Create a Rebuttable Presumption in Favor of Tribal General Welfare Programs

The ACT submits that it is important for Treasury to explore avenues for addressing the issue in a proactive manner, and to reduce the necessity of audits. The process must also achieve some certainty, while at the same time providing flexibility for tribes. There is, of course, an advance ruling process that can be implemented. But, this can be quite costly for tribes. Instead, the ACT suggests that Treasury (in consultation with tribes) explore the development of a process which permits tribes to take affirmative steps to develop their general welfare programs in a way that will provide either a safe-harbor or rebuttable presumption to shift the burden of proof to the IRS to establish that the particular tribal program has not met the General Welfare Exclusion.

The ACT contemplates that certain fundamental requirements for establishing a General Welfare Exclusion under a rebuttable presumption would be mandatory and incumbent upon the tribe to prove. But, once proved, they would not be rebuttable (except upon a showing of fraud or other extraordinary circumstances). These two non-rebuttable factors are:

- 1) payments are made pursuant to a legislatively-provided social benefit program; and
- 2) for the promotion of general welfare.

The first factor should be easily proved by providing evidence of the tribe's implementing action for the program (Resolution, Ordinance, etc.). Once proved, there should be nothing rebuttable about a *bona fide* legislative action; the tribes as sovereigns possess the exclusive jurisdiction to determine what programs will meet the needs of their members. That is not to say that other factors for meeting the General Welfare Exclusion may not be rebuttable by the IRS, but this initial factor should not be one of them.

The second factor would also be non-rebuttable. The tribe's determination of "general welfare" involves a policy expression by a sovereign, a political process, an intrinsic cultural ethos, a historic tradition, a response to historic disruption of tribal communities, or so on. In other words, the tribe's expression of what constitutes "general welfare" in the context of their tribe and nation will be unique and inherently unassailable. Indeed, essentially none of the historical IRS general welfare rulings take aim at the *bona fides* of a state's legislative act or its statement of the general welfare being served by the legislative act; the same deference should be given to tribal governments.

That said, the crux of the controversy typically arises not as to these first two factors, but as to the nature of the payment. That is, assuming the payment is not a form of compensation, is it reasonably calculated to meet a cognizable general welfare need?

The comments of tribes and their representative organizations suggest that a broader definition of a cognizable “need” is envisaged by the General Welfare Doctrine. The ACT agrees. At a minimum, the existing IRS rulings support a broader interpretation of “need” that is not limited to an expression of individual, financial need. See, *e.g.*, Rev. Rul. 57-102; TAM 200035007 (financial need is not the measure). Nor does it require a showing of individual need; the community as a whole is a legitimate beneficiary of social benefit programs. See, *e.g.*, Rev. Rul. 76-373.<sup>80</sup>

And, as we have discussed in this report, tribal governments serve a unique role in mediating the community need of members, unlike the common role of state and local governments. So, the General Welfare Doctrine as applied to tribes must embrace a new paradigm; one that accounts for the unique circumstances, traditions, roles, and functions of a tribal community.

Accordingly, a rebuttable presumption process would permit a tribe to establish the precise need it intends its program to meet, how the program is reasonably calculated to meet that need, how the program is administered to meet that need (i.e., that the tribe is, in fact, following its program guidelines), and that the actual benefit provided is reasonable and not excessive. The rebuttable factors would, therefore, be the following:

- 1) proof the payment is not compensation for services rendered by the recipient; and
- 2) proof the payment is reasonably calculated to meet an individual or community need, as defined by the tribal government.

The precise formula by which a tribe could satisfy the evidentiary requirements to create a rebuttable presumption is something the tribes and Treasury can work out through consultation and through the workings of the new tribal advisory committee/STAC. The ACT suggests there would be a minimum necessary threshold of proof for the tribe. And once proved, the IRS could only rebut the presumption if it develops sufficient contrary evidence to rebut the probative value of the tribe’s supporting documentation and data.

It is anticipated that a program “reasonably calculated” to meet the identified need would be reasonable in amount, and not excessive. That said, given the pervasive unmet economic, educational, and infrastructural needs throughout Indian country, it would be rare indeed that any tribal welfare program would have the means to provide for excessive benefits. Nevertheless, the tribal welfare program under this test would be one that is not intended to provide luxury or non-essential benefits (as that may be defined by reference to existing federal or tribal laws).

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<sup>80</sup> 1976-2 C.B. 16.

**B. Modify IRS Approach to “Disguised” or “Deemed” Per Capita Payments under IGRA**

The ACT further submits that a review and modification of the IRS application of Code Section 3402(r) withholding requirement, as it relates to general welfare payments, is necessary. In that regard, the ACT submits that it is improper and contrary to the intent of IGRA to re-characterize a general welfare program distribution as a deemed per capita subject to tax withholding under Code Section 3402(r). Such a presumption is likely to vitiate the Revenue Allocation Plan that has been approved by the BIA, particularly when the tribe has already distributed the total allocable percentage of per capita payments under its Revenue Allocation Plan for the year. To suggest that any distributions above that allocable per capita percentage are deemed per capita subject to Code Section 3402(r), would arguably violate the Revenue Allocation Plan limits on per capita payments. It is the exclusive jurisdiction of the Bureau of Indian Affairs to determine allowable per capita uses of gaming revenue; IRS re-characterization of program uses of net gaming revenue obviates BIA’s exclusive jurisdiction.

**C. Treasury Level Advisory Committee/Undersecretary of AI/AN Affairs/Tribal Consultation Policy Amendment**

The United States has a unique legal and political relationship with Indian tribal governments, established through and confirmed by the Constitution of the United States, treaties, statutes, executive orders, and judicial decisions. In recognition of that special relationship, pursuant to Executive Order 13175 of November 6, 2000, executive departments and agencies are charged with engaging in regular and meaningful consultation and collaboration with tribal officials in the development of federal policies that have tribal implications, and are responsible for strengthening the government-to-government relationship between the United States and Indian tribes.

The Department of Health and Human Services (HHS) has taken the lead among federal agencies in fulfilling its responsibility to comply with Executive Order 13175 by establishing the Secretary’s Tribal Advisory Committee (STAC).<sup>81</sup>

The Secretary of the Department of the Treasury should establish a similar STAC composed of the Treasury Secretary, the IRS Commissioner, senior Treasury and IRS officials, and representatives of tribes and national and regional inter-tribal associations throughout Indian country. The Secretary should also establish an Undersecretary for Tribal Affairs.

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<sup>81</sup> U.S. Department of Health & Human Services, IEA Tribal Affairs, <http://www.hhs.gov/iea/tribal/index.html>.

## **Treasury/IRS STAC**

The Treasury/IRS STAC purpose would be to seek consensus, exchange views, share information, provide advice and/or recommendations; or facilitate any other interaction related to intergovernmental responsibilities or administration of Treasury/IRS programs, including those that arise implicitly under policy or rule, or explicitly under statute, regulation, or Executive Order. This purpose will be accomplished through forums, meetings, and conversations between federal officials and elected tribal leaders in their official capacity (or their designated employees or national associations with authority to act on their behalf).

The Treasury/IRS STAC should include without limitation the following core functions:

1. identify historical, current, and evolving issues effecting American Indians and Alaska Natives (AI/AN) including Tax Policy, Domestic Finance, and Economic Policy;
2. apply the trust obligation of the United States government to tribal governments, and its responsibilities under the United Nations Declaration of the Rights of Indigenous Peoples (UNDRIP), to the Treasury Department's mission to build a strong economy and create economic and job opportunities in and for Indian country by promoting the conditions that enable economic growth and stability for tribes and on tribal lands;
3. to understand tax policy that respects AI/AN tribal government inherent rights and provides America's tribes top quality service by helping all parties understand and meet their trust and tax responsibilities and by developing standards for applying the tax law with integrity and fairness for all;
4. propose clarifications and other recommendations and solutions to address issues raised at tribal, regional, and national levels;
5. serve as a forum for tribes and Treasury/IRS to discuss these issues and proposals for changes to Treasury/IRS regulations, policies, and procedures;
6. identify priorities and provide advice on appropriate strategies for tribal consultation on issues at the tribal, regional, and/or national levels; and
7. ensure that pertinent issues are brought to the attention of Indian tribes in a timely manner, so that timely tribal feedback can be obtained.

The Treasury/IRS STAC should comprise positions filled by voluntary representatives: one delegate (and one alternate) from fourteen federally recognized tribes (one delegate and alternate from each of twelve Bureau of Indian Affairs (BIA) regions with two delegates and alternates from Alaska and California), and one delegate (and one alternate) for twelve



national or regional inter-tribal associations: (National Congress of American Indians (NCAI), United South and Eastern Tribes (USET), All Indian Pueblo Council (AIPC), Arizona Inter-Tribal Council (AITC), California Association of Tribal Governments (CATG), Affiliated Tribes of Northwest Indians (ATNI), Michigan Association of Sovereign Tribes (MAST), Alaska Inter-Tribal Association (AITC), Alaska Federation of Natives (AFN), Great Plains Tribal Chairman's Association (GPTCA), Inter-Tribal Council of Nevada (ITCN), and National Association of Financial Officers (NAFOA).

### **Treasury/IRS Tribal Consultation Policy**

We recommend the tribal consultation policy of the Department of the Treasury and the Internal Revenue Service be amended to include the following provisions:

*The Department of the Treasury shall adopt a policy of communication and consultation with all federally recognized American Indian and Alaska Native tribes. All department bureaus and agencies shall comply with the policy. The policy shall provide for timely and meaningful communication and consultation with Indian tribes and shall permit elected officials and other representatives of tribal governments to provide timely and meaningful input into the development of legislation, regulations, rules, and policies on matters that significantly or uniquely affect the AI/AN tribes. The policy shall require the state agency to communicate and consult with AI/AN tribes before the agency proposes legislation, or proposes or adopts regulations, rules, or policies that may materially affect AI/AN tribes.*

### **Undersecretary for Tribal Affairs**

The Undersecretary for Tribal Affairs office should be established to serve as the official point of contact for tribes, tribal governments, and tribal organizations wishing to access the Department of the Treasury. The Tribal Affairs office, to be effective, must be established within the immediate Office of the Secretary, report directly to the Secretary, and be the Departments' lead office for tribal consultation in accordance with Executive Order 13175-Consultation and Coordination with Indian Tribal Governments. Other duties and responsibilities of the Office of Undersecretary for Tribal Affairs should include:

- coordination and management of tribal and native policy issues and serve as the Department's expert and informational resource to the Secretary;
- provide executive direction for the Secretary's intradepartmental council;
- collaboration and outreach to tribes and national or regional Native organizations;

**Indian Tribal Governments:**

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- coordination of Department participation in national tribal meetings and tribal site visits for the Department's executive leadership;
- advice and assistance to the Department's executives and senior staff on tribal affairs;  
and
- coordination of the Secretary's policy development for tribes.

## **VI. Summary**

There is a sound policy and tax administration basis for either expanding the existing General Welfare Doctrine as it applies to tribes, or developing a discrete administrative exclusion applicable only to tribal governments and their members. The United States has made a commitment to protect tribes as separate sovereigns. One expression of that commitment is the federal decisional rule that federal laws should not be interpreted to invade upon a tribe's internal affairs. Accordingly, administration of the general welfare exemption with respect to tribal programs should acknowledge a tribe's role and authority to determine what is necessary for the general welfare of its members. Any guidance under the General Welfare Exclusion must be designed to be consistent with federal law and policy and must reflect the sovereign status of tribes, the federal trust relationship, and the federal policy of self-determination.

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**ADVISORY COMMITTEE ON  
TAX EXEMPT AND GOVERNMENT ENTITIES  
(ACT)**

**Tax Exempt Bonds:  
A Survey of IRS Form  
for Information Reporting**

David J. Cholst  
George T. Magnatta  
J. Sue Painter

**June 6, 2012**

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## **I. Executive Summary**

Before the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248) (“TEFRA”), there were no reporting requirements for issuers of tax-exempt bonds. With the enactment of TEFRA, Congress required certain tax-exempt bonds for private activities to report information regarding these bonds. Congress extended the reporting requirements to certain other tax-exempt bonds in The Tax Reform Act of 1984. In the Tax Reform Act of 1986, Congress extended to all tax-exempt bonds the information reporting requirements that were currently in existence for industrial development bonds, qualified mortgage bonds, qualified veterans’ mortgage bonds, student loan bonds, and bonds for Section 501(c)(3) organizations. The American Recovery and Reinvestment Act of 2009 (“ARRA”) created a new type of tax-advantaged bonds known as Build America Bonds which were also made subject to the information reporting requirements. This information reporting requirement was also extended to so-called specified tax credit bonds as part of their creation in the Hiring Incentives to Restore Employment Act. The principal forms related to tax-exempt and tax credit bonds are the 8038 series forms including Forms 8038, 8038-B, 8038-G, 8038-GC, 8038-R, 8038-T and 8038-TC. Schedule K which is attached to Form 990 must be filed by 501(c)(3) organizations benefiting from tax-exempt bonds.

This report surveys the history of information reporting for tax-advantaged bonds and the purposes for information reporting. The ACT has identified six different purposes that it considers as legitimate purposes for collecting information pursuant to the information reporting requirements. The IRS should carefully consider any information requested on a bond-related form that does not fit within one of these six purposes.

A detailed survey of the information requested on each of the bond-related forms is appended to this report. Also appended to this report is a suggested uniform Part I that the ACT recommends be utilized for each type of Form 8038. Finally, the ACT has also appended to this report a suggested Form 8038-N. This general purpose form could be used by issuers of tax-advantaged bonds that are required or encouraged to notify the IRS of certain post-issuance events (e.g., creation of a defeasance escrow as part of a remedial action).

The ACT commends the IRS for the timely production of the various forms it has produced throughout the last three decades, particularly during the period following the enactment of the ARRA. We believe that the time has come for the IRS to revisit the various forms to assure that they are fulfilling the original intended Congressional purpose. It is most important for the IRS to weigh the burdens of form completion against the benefits derived from the information to be requested.

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## II. Background and Proposal

### A. History of Information Reporting for Tax-Advantaged Bonds

Before the enactment of TEFRA, there were no reporting requirements for issuers of tax-exempt bonds for private activities.<sup>1</sup> Congress enacted several changes to the tax-exempt bond rules relating to private activities in TEFRA because Congress was “concerned with the volume of tax-exempt bonds used for private activities.”<sup>2</sup> Congress found that the “growth of private activity bonds in recent years has been large, [but] information concerning the specific uses was incomplete.”<sup>3</sup> As such, Congress enacted 1954 Internal Revenue Code (“1954 Code”) Section 103(l) to “enable the Congress and others to monitor the use of tax-exempt bonds for private activities and to help in enforcing other restrictions on (IDBs) [Industrial Development Bonds]” by requiring issuers to make reports to the Internal Revenue Service on private activity tax-exempt obligations.<sup>4</sup>

The information reporting requirements contained in 1954 Code Section 103(l) applied to all IDBs, student loan bonds, and bonds of which a major portion of the proceeds were used by organizations described in 1954 Code Section 501(c)(3). This requirement was effective for affected bonds issued (or refunded) after 1983. Unless there was substantial compliance with the information reporting requirements to the IRS, the interest on the bonds would not be exempt from federal income taxation.<sup>5</sup> Congress anticipated that the IRS would make “compilations and summaries of the reported information available to Congress and that this information will become a matter of public record at that time.”<sup>6</sup>

In the Tax Reform Act of 1984 (“1984 TRA”), Congress extended the qualified mortgage bond program contained in 1954 Code Section 103A for a four-year period through 1987. “In order to ensure an adequate basis for reevaluation [of the Mortgage Revenue Bond Program], Congress determined that qualified mortgage bonds should be subject to the reporting rules similar to the TEFRA information reporting requirements for private activity tax-exempt bonds” for qualified mortgage bonds or mortgage credit certificates issued after 1984.<sup>7</sup> This requirement was codified at 1954 Code Section 103A(j)(3)(A). The 1984 TRA specifically authorized Treasury to require information “enabling it to determine whether interest on the

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<sup>1</sup> *General Explanation Of The Revenue Provisions Of The Tax Equity And Fiscal Responsibility Act of 1982 (H.R. 4961, 97<sup>th</sup> Congress; Public Law 97-248)*. Prepared By The Staff Of The Joint Committee On Taxation (December 31, 1982), p .98.

<sup>2</sup> *Id.* at 98.

<sup>3</sup> *Id.* at 99.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.* at 102.

<sup>7</sup> *General Explanation Of The Revenue Provisions Of The Deficit Reduction Act of 1984 (H.R. 4170, 98<sup>th</sup> Congress; Public Law 98-369)*. Prepared By The Staff Of The Joint Committee On Taxation (December 31, 1984), p. 906-907.

issue qualified for tax-exemption and the extent to which the proceeds of the issue are made available to low-income individuals.<sup>8</sup>

The 1984 TRA also extended the Internal Revenue Code requirements relating to tax-exemption to bonds that derived their tax exemption from federal law other than the 1954 Code. The 1954 Code requirements that extended to these bonds included the information reporting requirements if the characteristics of such non-Code bonds were, in substance, IDBs.<sup>9</sup> This requirement was codified at 1954 Code Section 103(m).

With respect to qualified mortgage bonds (“QMBs”) issued after 1984, an issuer is required to submit an annual report to the IRS with information regarding the borrowers of the original proceeds of such QMBs.<sup>10</sup> “Although the legislative history for the TRA [Tax Reform Act of 1986 (“1986 TRA”)] seems to indicate the intent of Congress was to repeal this requirement, the Internal Revenue Service has taken a contrary view in the [Treasury] Regulations.”<sup>11</sup> The ACT recommends that this Treasury Regulation be repealed because it appears that this information is not utilized by the IRS for any purpose. In any event, the IRS is able to request the same information by asking for the information on an information document request (“IDR”) if a QMB is under examination.

In the 1986 TRA, Congress extended to all tax-exempt bonds the information reporting requirements that were currently in existence for IDBs, qualified mortgage bonds, qualified veterans’ mortgage bonds, student loan bonds, and bonds for Section 501(c)(3) organizations.<sup>12</sup> These amended and restated information reporting requirements were codified at Internal Revenue Code of 1986 (“1986 Code”) Section 149(e). The information required under the 1986 Code was the same as that required under the 1954 Code. The 1986 TRA authorized the Department of the Treasury (“Treasury”) “to vary the specific information that is required” for governmental bonds because certain of the information required for other types of bonds is not necessarily relevant in the case of pure governmental bonds (e.g., specific types of facilities financed).<sup>13</sup> The Congress also recognized that the Treasury should have the ability to waive the penalty of loss of tax exemption for a late filed information return if not due to willful neglect.<sup>14</sup> Finally, Congress noted that governments sometimes issue in small amounts, and, in such a case, should be able to file a consolidated information return for such small issuances.<sup>15</sup>

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<sup>8</sup> *Id.* at 911.

<sup>9</sup> *Id.* at 951-952.

<sup>10</sup> *Treasury Regulation Section 1.103A-2(k)(2)(ii).*

<sup>11</sup> *ABCs of Housing Bonds*, p. 103, Packard Press, 5th Edition by Joseph P. Rogers, Jr. and Howard Zucker.

<sup>12</sup> *General Explanation Of The Revenue Provisions Of The Tax Reform Act of 1986 (H.R. 3838, 99<sup>th</sup> Congress; Public Law 99-514)*. Prepared By The Staff Of The Joint Committee On Taxation (released May 7, 1987), p. 1223.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 1223-1224.

Section 1531 of Title I of Division B of the ARRA<sup>16</sup> created a new type of tax-advantaged bonds known as Build America Bonds (BABs), which permitted states and localities, at their option, to issue either of two types of BABs: (i) Build America Bonds (Tax Credit), and (ii) Build America Bonds (Direct Pay).<sup>17</sup> Additionally, Section 1401 of ARRA added a third type of BAB (Direct Payment) known as Recovery Zone Economic Development Bonds (Direct Pay) (“RZEDB”).<sup>18</sup> The IRS announced in “Frequently Asked Questions on Build America Bonds and Recovery Zone Economic Development Bonds” that the information reporting requirements of 1986 Code Section 149(e) applied to BABs.<sup>19</sup>

As such, before the publication of Form 8038-B, the IRS in 2009 required the issuers of direct payment and tax credit BABs and RZEDBs to report the issuance of BABs on Form 8038-G, Information Return for Tax-Exempt Governmental Obligations.<sup>20</sup> Thereafter, the IRS released Form 8038-B, Information Return for Build America Bonds and Recovery Zone Economic Development Bonds, and instructions thereto. The new Form 8038-B was to be used by issuers to report the initial issuance of BABs (both direct pay and tax credit) and RZEDBs.

The IRS also released Form 8038-CP, Return for Credit Payments to Issuers of Qualified Bonds, and instructions thereto. This new form was intended to be used by BAB and RZEDB issuers who are requesting refundable tax credits.

Section 301 of the Hiring Incentives to Restore Employment Act (“HIRE Act”)<sup>21</sup> amended 1986 Code Section 6431 to permit issuers of certain other tax credit bonds (“Specified Tax Credit Bonds”) to irrevocably elect to receive direct payments of refundable tax credits in lieu of the federal tax credits that would otherwise be allowed to holders of certain tax credit bonds under 1986 Code Section 54A. 1986 Code Section 54(d)(3) states that an issue is treated as qualifying for this new direct payment if the issuer submits reports similar to the reports required under 1986 Code Section 149(e). The IRS released Form 8038-TC, Information Return for Tax Credit Bonds and Specified Tax Credit Bonds, in mid-2010. Because of the HIRE Act’s addition of Specified Tax Credit Bonds as an additional category of bonds qualifying for the refundable tax credit, the IRS revised Form 8038-CP to apply to direct pay BABs, RZEDBs and Specified Tax Credit Bonds.

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<sup>16</sup> Public L. No. 111-5, 123 Stat. 115 (2009) which was enacted on February 17, 2009.

<sup>17</sup> See 1986 Code Section 54AA.

<sup>18</sup> See 1986 Code Section 1400U-2.

<sup>19</sup> See “Frequently Asked Questions on Build America Bonds and Recovery Zone Economic Development Bonds,” Question 5.

<sup>20</sup> See IRS Notice 2009-26, Section 5.

<sup>21</sup> Public L. No. 111-147, 124 Stat. 71 (2010). This option is applicable to New Clean Energy Bonds (as defined in 1986 Code Section 54C), Qualified Energy Conservation Bonds (as defined in 1986 Code Section 54D), Qualified Zone Academy Bonds (as defined in 1986 Code Section 54E), and Qualified School Construction Bonds (as defined in 1986 Code Section 54F).

## **B. Forms Related to Tax-Advantaged Bonds**

The principal forms related to tax-exempt and tax-credit bonds are the 8038 series forms including Forms 8038, 8038-B, 8038-CP, 8038-G, 8038-GC, 8038-R, 8038-T, and 8038-TC (and schedules thereto). Also relevant is Schedule K to be attached to Form 990 filed by 501(c)(3) organizations benefiting from tax-exempt bonds. Certain other forms including Forms 8328 (Carry Forward of Unused Volume Cap) and 8703 (Annual Certification of a Residential Rental Project) may also relate to tax-exempt bonds. However, our analysis contained herein is based on the 8038 series forms and 990 Schedule K.

## **C. Purposes for Information Reporting**

There are several purposes for the collection of information pursuant to the information reporting requirements. The ACT has identified six different purposes that we consider as legitimate purposes for collecting information pursuant to the information reporting requirements. We request that the IRS carefully consider any information requested on a bond-related form that does not fit within one of these below described purposes. While there are certainly reasons for collecting other information, the ACT submits that any information not within the purposes discussed below should not be collected because the benefits of collection outweighs burden imposed on the issuer. The six (6) enumerated purposes are as follows:

- i. Identifying information. Generally this information is found in Part I of each of the Forms 8038. Information that allows the IRS to identify the bond issue -- to which the information relates and the parties to the transaction -- is clearly important and necessary.
- ii. Information that affords the IRS the ability to determine the amount of a payment being made with the form or requested by the form (e.g., Forms 8038-T, 8038-R and 8038-CP).
- iii. Information that allows the IRS and Treasury to compile statistics on the use of tax-advantaged financings. This is the original purpose of information reporting.<sup>22</sup> Congress expects the periodic reporting of such statistics. A tendency to over-collect information may exist for the oft chance that the Treasury and Congress may need it for some currently unknown purpose. Any data collected for statistical purposes should be tied to anticipated, statistical questions. In particular, using the purpose of statistical collection should not justify the collection of detailed data without a specified purpose for its collection for statistical analysis.

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<sup>22</sup> See *Infra* "Background—History of Information Reporting for Tax-Advantaged Bonds."

iv. Information used to classify bond issues for IRS examination or other contact to determine if the rules relating to tax-exempt bonds are met. This purpose for information reporting should not be used as a substitute for document requests by the IRS to be given to issuers after a bond issue has been selected for examination. It is much less burdensome to request issuers under examination for information than to request all issuers to provide the information on a 8038 series form. Information collected that can be used to determine which bond issues should be examined is a proper purpose. Care should be employed to assure that the question being asked actually is related to such classification purpose.

v. Certain forms provide a place to record elections or identifications made by the issuer. For example, bank qualification and identification of a hedge are solicited questions on certain 8038 series forms. Although the form may request such information, the tax regulations typically require that such elections or identification be made on the issuer's "books and records" and not on a tax return. Hedge identification is required by the substantive tax regulations to be noted on certain forms. The ACT believes that recording elections and other documentation on a form should be required only if it also serves one of the other enumerated purposes discussed herein.

vi. Requiring information to be reported may educate issuers and others concerning tax law requirements for tax-exempt bonds. Sometimes the answer is not as important as the question. While the ACT recognizes that this may be a useful purpose of information reporting, the ACT believes that there are generally less burdensome methods of educating issuers and others with respect to the tax law requirements for tax-exempt bonds. Where questions are included on forms for this purpose, it is often appropriate to limit the question to a check box. Questions on the current Form 8038-G, relating to the existence of procedures for certain compliance items, are an example of items included for this reason.

#### **D. Burden of Information Reporting**

The IRS should endeavor to take into account the burden imposed on the issuer and others with respect to the reporting of certain information compared to the goals to be achieved from such reporting. The ACT is concerned that much of the information requested on the various 8038 series forms or in the instructions thereto do not have clearly defined goals to be achieved from the collection of such information. Furthermore, much of the requested information is required to be provided, with a degree of accuracy that does not further the legitimate objectives of the IRS, and which cannot easily be answered.

Attached hereto as Appendix A is a chart outlining many of the items requested on the 8038 series forms and Form 990, Schedule K.

Although Schedule K to Form 990 is required only for tax-exempt financings that benefit 501(c)(3) organizations, it is arguably the most burdensome information reporting form for tax-exempt bonds because it must be completed annually. The ACT notes that, from time to time, there has been discussion regarding the expansion of periodic information reporting to governmental bonds. The ACT firmly opposes any such expansion, and questions the legal basis upon which such expansion could be accomplished. However, if such expansion were to be implemented, it is very important for the IRS to carefully weigh the burdens of any added periodic reporting requirement against the reasonable benefit to the IRS, Treasury, and the Congress.

Although there are many burdensome elements of the current forms that are specific to individual line items, certain common elements are presented, including:

- excessive accuracy requirement;
- required use of attached schedules;
- required identification of persons not important to tax administration;
- inconsistencies between forms;
- non-accommodation of conduit borrowers; and
- poor contact and identification requirement.

#### **E. Excessive Accuracy**

Much of the numerical information requested on the form is required by instructions to be provided with a specific high degree of accuracy. We do not believe that such accuracy requirement serves the specific purposes or justifies the burden involved. Among such accuracy requirements are: dollar amounts to the nearest dollar; yields to the nearest .0001% (sometimes truncated rather than rounded); and private use percentage to the nearest 0.1%.

Requiring that: amounts on the form be provided to the nearest dollar; the yield be provided to four decimal places; and amount of private business-use be provided to one tenth of a percentage point are more than just requiring an issuer to do a computer computation. In order for such quantities to be accurate to the level requested in the instructions, the inputs must also be known to a very high degree of accuracy. For example, one cannot compute yield to the nearest .0001% unless issue price is known to an absurd level of accuracy. Fortunately, the substantive tax rules and regulations governing tax-exempt bonds do not demand knowledge of the inputs with such accuracy. Many bond issues comply with all applicable bond rules and regulations even though the issuer may not know such items as the



“issue price” of the bond issue to the nearest dollar. When such bonds are issued, issuers and the professionals make conservative assumptions. It is the practical way that tax-exempt bonds may be issued.

For example, a bond issuer in reliance on information from its bankers may believe that the issue price of a bond is par. However, on a thirty-year bond, an increase of only \$15 per \$1,000,000 of issue price would decrease the yield by more than the mandated 0.0001%.

Even if all inputs are known, resulting calculated values may vary greatly depending on conventions used for calculation. Neither the substantive law nor the form instructions specify such conventions.

The instructions to the information reporting forms do not specify the compounding period or other conventions that may be used to calculate the bond yield. Use of monthly or semiannual compounding would have a much bigger effect than the .0001% limit. For example, a yield of 5.00% with semiannual compounding is equivalent to approximately a yield of 4.95% with monthly compounding (using the same day counting conventions). Even day counting conventions (again not specified in the instructions) could have a great effect on the reported number. Popular day counting conventions include actual/actual, 30 day months/360 days, actual/365, actual/360. Rules related to the treatment of the last day of the month may also affect computations. Substantive law requires use of the same compounding intervals and the same conventions for bond yield and investment yield computations. Thus, the compounding and conventions used generally do not affect the rebate amount.<sup>23</sup> They do, however, affect the value of “yield” often by much more than the specified accuracy.

The substantive tax regulations related to yield restriction and arbitrage rebate mandate computation to four decimal places, and presumably the accuracy requested in the form is derived from these regulations. The tax regulations impose a manageable burden on issuers. That is because, in the end, the issuer just needs to pay enough rebate or make a yield reduction payment. No bond could ever be declared taxable because the issuer paid \$50 too much rebate. Reporting to a high degree of accuracy does not allow a similar balancing of burdens and benefits to be used in completing the form.

The IRS should consider the purpose for which the information is gathered. For fixed rate bonds, gathering bond yield information at the time of issuance may be helpful to the IRS. For example such information may provide insight on the benefits received by the issuer

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<sup>23</sup> We note that certain substantive tax law requirements permit an offset to bond yield. For example, in many cases investments are limited to bond yield plus 1/8%. Compounding intervals are often relevant to such spreads. An investment yield may be less than bond yield plus 1/8% compounded monthly, but greater than bond yield plus 1/8% when compounded semi-annually. Possibly because the effects are relatively small, the substantive law does not specify a required compounding interval (and does not vary the allowed spreads according to compounding interval). We also note that day count conventions may have small effects on rebate amounts, particularly when cash flow is received on the 31st of a month, or a bond issue closes on the 31st of a month.

from tax exemption. It may be used to predict the eventual arbitrage rebate liability both for a specific transaction and more importantly for bonds generally issued at a particular time or of a particular type. However, these purposes may be served very well if bond yields were reported to the nearest 0.1% rather than 0.0001%. Additionally, if the IRS is to make any use of the information, it should require specific computational conventions or ask for the conventions used. Without knowledge of conventions, any more accuracy than 0.1% is meaningless.

Demanding high levels of accuracy may actually serve to reduce the respect that should be afforded IRS requests for information. In some cases, it may lead to less rather than more useful information reporting.

For example, the current Form 8038-G requires that the issuer provide the amount of bonds (to the nearest dollar) that are used for each of a variety of purposes (e.g., education, public safety, transportation, etc). It is appropriate for the IRS to collect information that may be used to report back to Congress on the portion of tax-exempt bond issues used for health, education, utilities, environment, or public safety. However, when cities or states or other multi-purpose entities issue governmental bonds, it is likely that the bonds will be used for multiple purposes. Often any attempt to break down the bond issue into such components (although required by the forms and instructions) is no more than an estimate. It is certainly not accurate to the nearest dollar. Any benefit to the IRS, Treasury, or Congress to have such information to the nearest dollar is questionable. It is certainly not needed to provide a report to Congress providing statistics on the use of tax-exempt financings. Accuracy to 10% of the issue size is probably sufficient for statistical reporting and classification purposes.

Some issuers when faced with the problem of specifying the amount used for each of various purposes instead simply check the “Other” box and enter some indication of the multi-purpose nature of the financing (e.g., general municipal purposes). If less accuracy were requested, more useful data might actually be collected.

#### **F. Forms Do Not Reflect Instructions; Instructions Ask for Potentially Irrelevant Information**

The instructions to the 8038 series forms, in certain cases, request a large amount of information for which there is no dedicated location on the particular form. For example, Form 8038 asks for the name of the approving governmental entity that provides TEFRA approval. However, the instructions require the entry of the date of approval and the date of the hearing. If this data is important (and it may be), the form should have a line item for such information.

The instructions, to Form 8038-G, request that an issuer provide a list of all users of the bond-financed facilities, along with their tax identification numbers. Often there are users of

bond-financed facilities whose use has no effect on the tax-exemption of the issue. For example, such users may be using only a de-minimis portion of the bond-financed property, or the issue may fail to satisfy the private payment or security test. In such case, the requested information is not useful for enforcement and not particularly useful for statistical purposes. Also, since the information is only to be provided on an attached user generated schedule, it forces issuers to create additions to the forms in a non-uniform way.

It appears that there has been a proliferation of data requested by the instructions which is to be inserted on attached schedules. This makes the forms less useful to the IRS as well as much harder to complete. We believe that the IRS should embrace the idea of standardized schedules to be attached to its forms on which such information may be reported. We note that the schedules created for Form 8038-TC use this concept. We believe that requiring information in a particular format enhances the usefulness of the information. We also believe that use of schedule forms for this information would assist in reducing the amount of irrelevant information reported.

### **G. Accommodation of Common Situations**

Forms should be designed to accommodate situations without forcing issuers and others to resort to labor intensive negotiations, or use of fields to accomplish something they were not designed for. Our suggestion of reducing the accuracy requirements helps in this regard.

Sometimes an issuer may lack information required on the form. Delay of filing until the information becomes available could cause the form to be filed late. An issuer wants to file timely and wants to collect the required information and file an amendment within a reasonable time. To accommodate this, we recommend that some or all the forms (and in particular, Form 8038-T) be allowed to be filed as preliminary or estimated. A box could be positioned in a manner similar to the amended form box. If this box is checked:

- i. the form signor will not be certifying that the form is complete, and will be certifying only that the information provided represents the signor's estimate at this time; and
- ii. in order to be considered filed timely, a completed form (without the preliminary box being checked) must be filed within a specified period [e.g., 90 days] of the original due date of the form.

Recognizing that a payment, made with such a preliminary Form 8038-T, might be in the wrong amount, an underpayment might nonetheless subject an issuer to a penalty. However, if the full required amount is paid with interest no later than the time the amended return is due (e.g., 90 days later), then the prompt payment along with the notification inherent in

filing the estimated or preliminary Form 8038-T should be taken into account in any decision by the IRS to waive a penalty. Finally, penalty and late interest will be avoided for the portion of any payment made timely with the estimated or preliminary form, so long as the form is completed within the specified period.

## **H. Good Faith Efforts; Penalties of Perjury**

We note that Treasury Regulations §1.149(e)-1(d)(1)(i) state that a form is considered timely filed if the issuer files a form that is completed with a “good faith effort.” Thus, it appears that the tax-exemption of bonds does not depend on the extreme accuracy currently being requested by the IRS. However, the required accuracy does raise questions given that the forms must be signed under penalty of perjury and given the existence of paid preparer penalties. As a practical matter, it would seem absurd to sanction an issuer or a paid preparer for completing a form in a way that has no meaningful effect on tax matters.

## **I. Reporting Authority**

Each of the 8038 series forms includes a Part I relating to Reporting Authority. This section appropriately requests the person completing the form to provide identifying information and contacts. We believe that a uniform approach to this section of the form is appropriate. We are particularly bothered by differences that serve to limit the flexibility in certain forms while allowing it in others.

Many tax-advantaged bond issues are “conduit” transactions in which an entity other than the issuer of the bonds is the principal user of the bond-financed facilities. The only form (besides the Schedule K which is generally completed by a conduit borrower) that appears to recognize the importance of the conduit borrower is the Form 8038-R. Form 8038-R (on line 22—not part of Part I) permits the issuer to indicate a contact at the conduit borrower (or other non-governmental user of bond proceeds) if the issuer so chooses to do so. This option should continue to be available, should be part of the Part I block, should apply to all forms, and should apply to governmental as well as non-governmental users of bond proceeds.

Several Forms 8038 provide for a contact other than the issuer to be provided on the form at the option of the issuer. We believe that such an optional contact can be useful, particularly if certain modifications described herein are made. Currently, the forms are not uniform as to the placement of this optional information. Such option should be in addition to the option to list a conduit borrower contact.

One possible category of contacts that could be listed for such non-issuer contacts are professionals including the tax form preparers. However, the current forms and instructions need to be revised. Forms 8038, 8038-G, 8038-B, and 8038-TC are most often prepared by bond counsel. Bond counsel have generally been unwilling to be listed as a contact because

of the open-ended nature of the authorization. Typically bond counsel's role in the transaction ends when the bonds are delivered. For ethical reasons, including avoiding legal conflicts of interest, it is important to tax practitioners under IRS Circular 230 (Section 10.29 in particular) to end the representation of an issuer quickly and decisively. (State legal conflicts of interest rules also apply.) Bond counsel are very concerned that any authorization permitting them to be contacted by the IRS effectively keeps the attorney-client relationship alive. If such authorization extended only for a short and reasonable period after closing, many counsel would be willing to keep the attorney-client relationship active for this period. Because these counsel or other practitioners are often the most knowledgeable about the form and the bond transaction, it makes sense to list them as contacts. Often a short conversation with such counsel is all that is necessary to answer the IRS questions about the form and the transaction. Therefore, in order to encourage this type of authorization, a reasonable time limit for such authorization should apply. Either the instructions could specify a period of not more than ninety (90) days after filing to which the authorization applies, or the form itself could include a line to enter an expiry date for such authorization.

Often, even if an outside party is authorized to receive correspondence from the IRS, an issuer also wants to receive copies of any written correspondence and notification of oral correspondence received pursuant to such authorization. We note that the IRS Power of Attorney form generally provides that the issuer has the option to receive such correspondence. We strongly recommend that the form provide a box to check if the issuer wants such notification. We believe that a similar box should also apply to any authorized contact of the conduit borrower.

The issuer contact information is important and should be provided even in cases where an outside contact is provided. Some of the current forms have only one line for a mailing address. If that line is used for an outside contact, no issuer address will be provided. We note that many issuers have specific offices dedicated to bond-related matters. Use of a general mailing address for an issuer taken from forms unrelated to bond matters is often inappropriate. Any attempted correspondence made using such general contact information is highly likely to get lost or at least add long periods to the time that is needed for a meaningful response.

## **J. Issue Identification**

In many of the forms, the Committee on Uniform Security Identification Procedures (CUSIP) number is used to provide a simple identification of the bonds to which the form relates. Unfortunately, use of the CUSIP number is not always suitable for this purpose. For example, bonds in certain variable rate modes may have frequently changing CUSIP numbers. Even fixed rate bonds can have new CUSIP numbers provided to the same bonds at a later date. For example, new CUSIP numbers are often provided when bonds have been provided for with escrowed investments. Of course, CUSIP numbers are not always

assigned. Finally many bond issues have more than one CUSIP number assigned to bonds of the same (and final) maturity. The business that provides the CUSIP information is a private business entity. It does not seem appropriate to give any special deference to a private company. We note that Forms 8038-TC and 8038-B have special CUSIP related items. Those forms are concerned with the tracking of tax credits that may be stripped. Any such use of CUSIP is separate from the use of CUSIP as an identifier of the bond issue.

Once an identifier is assigned, whether or not it is based on the use of a CUSIP, it should remain with the bond issue. Therefore, for forms that are filed other than in connection with an initial bond issuance (e.g., Schedule K and Forms 8038-CP, 8038-T and 8038-R), the instructions should request that the identifier entered on the first form filed, with respect to the issue, be used for the issue's duration even if CUSIP numbers are later changed. We note that the IRS assigns a "report number" to each form filed. The report number of the first form filed for a bond issue could be used for linking subsequent forms (Forms 8038-T, 8038-R, 8038-CP, 990 Schedule K) to the issue. However, because the report numbers are completed by the IRS and are reported back to the issuer in a way that does not ensure that the report numbers remain part of the permanent record of the issuer, the ACT does not recommend using those report numbers to link different forms together.

#### **K. Suggested Uniform Reporting Authority Form Section**

Below is a list of items that **SHOULD BE** included in Part I of each type of Form 8038. Instructions are also provided below. In Appendix B, attached hereto, is a suggested form of Part I of each 8038 series forms. Proposed instructions are attached to that suggested form.

1. Issuer name
2. Issuer EIN
3. Issuer number and street (or P.O. box)
4. Report Number (to be completed by IRS)
5. Issuer city, town or post office, state and ZIP code
6. Date of issue
7. Name of issue
8. Unique identifier for bond issue (may use CUSIP initially assigned)
- 9a. Name and title of officer or other employee of the issuer whom the IRS may call for more information
- 9b. Issuer contact telephone number
- 10a. Name of substantial user if other than the issuer
- 10b. Tax ID number of substantial user
- 10c. User contact name and title (optional)
- 10d. User contact telephone (optional)
- 10e. User contact number and street (or P.O. box)

- 10f. Check Box if issuer authorizes contact of user
- 10g. User contact city, town or post office, state and ZIP code
- 10h. Check Box if issuer is to be copied on all correspondence
- 11a. Non-issuer, non-user contact (optional)
- 11b. Non-issuer, non-user telephone (optional)
- 11c. Non-issuer, non-user contact number and street (or P.O box)
- 11d. Expiration date of authorized contact
- 11e. Non-issuer, non-user contact city, town or post office, state and ZIP code
- 11f. Check Box if issuer is to be copies on all correspondence

## **L. New Form for Notification**

There are several situations under which issuers of tax-advantaged bonds are required to or are encouraged to notify the IRS of situations that may have developed. Some of these are codified in Treas. Reg. §1.150-5. For example, under Treas. Reg. §1.141-12(d)(3), an issuer is required to notify the Commissioner of the creation of a defeasance escrow as part of a remedial action correcting a change in use. Unfortunately, there is not at present any consistent method of providing such notice; and TEB may have difficulty tracking such notifications and linking them to the appropriate bond issue. We suggest that a general purpose form be created that can be used for this purpose. Such a form, which we would label -- Form 8038-N (for Notice), would be short and versatile. It would contain a Part I (Reporting Authority) and a series of questions about specific types of notices including the establishment of a defeasance escrow. It would also contain a free form field for the issuer to set forth other types of notifications that may arise in the future. Note that under Treas. Reg. § 1.142(f)(4)-1, only the “local furnisher,” who is almost always a conduit borrower, may provide the notice. Therefore, it is most important that Form 8038-N provide that it may be signed by a conduit borrower. It is our belief that many of the forms should be permitted to be signed by conduit borrowers including Forms 8038-T and 8038-R.

One specific type of notification, that we think appropriate, would be a notification that the issue has been paid in full. There is, of course, no legal requirement that such notice be provided. We believe, however, that many issuers would voluntarily provide such notification because the issuer would anticipate that providing such notification would, in short order, end future scrutiny of its bond issue. TEB would benefit because it would gain information that would naturally focus its attention on bond issues that remain outstanding.

A suggested version of Form 8038-N is attached as Appendix C.

## **M. Electronic Filing**

The vast majority of 8038 series forms are prepared by paid preparers. The initial forms (8038, 8038-G, 8038-B, 8038-TC, but not 8038-GC) are most often prepared by bond counsel. Under current standard practice, that initial form is signed by the bond issuer and delivered to a bond counsel who then files the form by mail (or other delivery service). While bond counsel vary in the number of forms prepared, some bond counsel prepare hundreds of 8038 series forms each year. Certainly a large majority of these forms are prepared by preparers who develop routines related to the filing, and would be very appreciative of an opportunity to file electronically.

The 8038-T forms are most often prepared by firms providing such services to large numbers of issuers. These firms include services associated with law firms, accounting firms, financial advisory firms, banks, and stand alone rebate consulting firms. Again 8038-T forms are prepared by one firm for many issuers.

The 8038-CP forms are in many cases prepared by banks serving as paying agent or trustee. These banks would also have the volume of practice to benefit from and take advantage of electronic filing, if it were available. Some 8038-CP forms are prepared internally by the issuer. Such issuers may not prepare a large volume of forms but they will likely file at least two forms per year, making them reasonable candidates to take advantage of electronic filing, should it be available. Should electronic filing become mandatory, such filers would find electronic filing to be acceptable.

The 8038-GC forms are most often prepared and filed by the lender or vendor. Such vendors and lenders file a large number of 8038-GC forms on behalf of the issuers signing the forms. Once more, there is a significant concentration of 8038-GC forms through a single entity in charge of the filing process.

We note that Form 8038-R, and the proposed Form 8038-N, will be filed much less frequently than other 8038 series forms, and would benefit less from the availability of electronic filing.

We recommend that Forms 8038, 8038-B<sup>24</sup>, 8038-G, 8038-GC, 8038-TC, 8038-T, and 8038-CP be allowed to be filed electronically, and perhaps be required to be filed electronically if the firm preparing the forms files at least 50 such forms each year. Forms 8038-R and 8038-N (if adopted) could be added to electronic filing at a later date.

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<sup>24</sup> The ACT recognizes that Form 8038-B is currently obsolete because no bond issues requiring the form are currently authorized to be issued. We have included Form 8038-B in the list because the principles and practicality related to filing Form 8038-B are similar to those related to file Form 8038-G.



We think that the easiest way to implement such electronic filing is to ask each firm that wants to file electronically, or is required to file electronically, to register and be assigned a unique log-in sequence. Software could be utilized that would allow all of the fields found now on the printed forms to be completed on line or on machine readable media that could then be delivered to the IRS campus (Service Center). We recommend that a single checkbox be added to each form eligible for electronic filing authorizing the paid preparer to file the form electronically. If such a box is checked, the physical form would not be sent to the IRS, but would be retained by the paid preparer.

Any software used to file electronically should be designed to produce a receipt showing that the form has been filed. If this receipt could be designed to include a report number, that would be beneficial.

The only 8038 series form that is filed with a payment is Form 8038-T. A system allowing EFT payments would be highly desirable, but as an alternative, we propose a new form, Form 8038-V, that would include only a section identifying the issue to which it relates (Part I) and a single line item asking for the amount being paid. The electronic version of Form 8038-T could then allow a click to indicate that the amount of the payment as indicated on Form 8038-T is being filed separately with Form 8038-V. If a Form 8038-V is so created, the information requested should be kept to a minimum; and there is no need to have the form signed. It should be treated as a voucher similar to the vouchers used to pay personal income tax (1040-V or 1040-EST).

There are several places where the current instructions to 8038 series forms require the inclusion of free form schedules. As stated earlier, we think that, in many cases, such schedules can be replaced with formatted published schedules that can be included in the electronic filing software. Since this may not always be possible, or cost effective, we recommend that the software allow a free form attachment in a suitable format (e.g. a pdf file attachment).

## **N. Obstacles to Form Revision**

We recognize revision of the forms requires examination of programming architecture, timing of review process, economic considerations, and other factors which could preclude or delay adoption of some of these recommendations. The ACT understands that wholesale revisions to the forms might take years to accomplish. However, we offer observations that we feel, if consistently applied across all forms, could potentially reduce reporting errors, reduce the burden of form preparation, and provide more relevant data consistent with the aforementioned purposes for information reporting.

### **III. Conclusion**

Generally, the IRS is to be commended for timely production of the various forms throughout the last three decades, particularly during the period following the enactment of the ARRA. We think that the time has come for the IRS to revisit the various forms to assure that they are fulfilling the original intended Congressional purpose. It is most important for the IRS to weigh the burdens of form completion against the benefits derived from the information to be requested.

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**Appendix A. Line by Line Analysis**

<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>THIRD PARTY COMMUNICATION</b>	8038	Part I, Line 3a.	Issuers have the ability to specify someone other than the Issuer who the IRS may contact regarding any questions it may have with respect to the answers on the Form. If the Issuer authorizes a person other than the Issuer's representative to interface with the IRS regarding the information on the Form, then Part I, Lines 4 & 6 require that the authorized person include his/her address. If the Issuer does not specify someone on Line 3a, then Lines 4 & 6 must specify the Issuer's address. The Form should require that both the Issuer's address and the authorized person other than the Issuer, if so specified, should provide their addresses. This is necessary in the event that the authorized person on Line 3a for example, is not responsive or has changed jobs. In such a case, the Issuer should also be furnished with a copy of any correspondence regarding the Form. We have provided a "universal" version of Part I contained in Appendix B to this Report that makes these changes.
<b>TELEPHONE NUMBER</b>	8038	Part I, Line 10b	Similarly, if the Issuer provides a name of an authorized contact person in Line 3a, then the Form should also request that person's telephone number.
<b>CUSIP NUMBER</b>	8038	Part I, Line 9	If CUSIP numbers are used as a cross-reference to link other Forms executed for the same issue of bonds, it may be more appropriate to use some other means of designation. CUSIP numbers may change between the time the Issuer executes one Form for the issue and then executes another Form with respect to the same issue (e.g., Form 8038-T). For example, when the last maturity date of a bond issue has been partially defeased, new CUSIPs are assigned to both the defeased bonds and the remaining outstanding bonds. The solution should be to always use the CUSIP first provided even if a new CUSIP has been issued.
<b>TYPES OF ISSUE</b>	8038	Part II	This Form elicits information regarding qualified private activity bond issues and certain other types of so-called non-governmental bonds. There are many types of bonds that an Issuer has the choice of checking. It is likely that certain of these types of bond issues are not checked on this Form as other types of bond issues. The IRS could significantly abbreviate the length (currently 2.5 pages in length) of this Form by retaining the most utilized types of bond issues and then utilizing the line denominated "Other" for the less utilized types of qualified private activity bond issues whereby the Issuer could type in the relevant type of facility and reference the Code section in which it finds its exemption (e.g., Qualified Redevelopment Bond, Section 144 (c)). The Instructions should retain the detail regarding the different types of facilities. In order to avoid confusion with other uses of the phrase "type of issue" (for example on the Form 8038-G), the IRS should consider using a different name for this concept. Perhaps, "Type of Qualified Issue."

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>QUALIFIED NONHOSPITAL BOND</b>	8038	Part II, Line 18	The Instructions to Line 18 should clarify how-current refunding bonds issued after August 6, 1997, are treated for purposes of the \$150 million limitation.
<b>REMAINING WEIGHTED AVERAGE MATURITY (WAM) OF CURRENT REFUNDING BONDS</b>	8038	Part VI, Line 33	The Instructions should be clarified as to what WAM(s) is required to be inserted on Line 33 in the case of a bond issue which is currently refunding all or a portion of multiple prior issues. Is it the aggregate remaining WAM of the bonds being refunded; or does the IRS want the Issuer to include multiple numbers indicating individual remaining WAM of the bonds of each issue which is being refunded?
<b>REMAINING WAM OF ADVANCE REFUNDING BONDS</b>	8038	Part VI, Line 34	The Instructions should be clarified as to what WAM(s) is required to be inserted on Line 33 in the case of a bond issue which is advance refunding all or a portion of multiple prior issues. Is it the aggregate remaining WAM of the bonds being advance refunded; or is it a list of the individual remaining WAM of the bonds of each issue which is being refunded?
<b>PENALTY IN LIEU OF REBATE</b>	8038	Part VII, Line 39	This section is used very infrequently; and we recommend it be eliminated.
<b>HEDGE PROVIDER</b>	8038	Part VII, Line 40b	The name of the hedge provider is not relevant for any classification or statistical reporting purpose. We recommend elimination of this line on the form.
<b>GIC PROVIDER</b>	8038	Part VII, Line 42c	The name of the GIC provider is also not relevant for any classification or statistical reporting purpose. We recommend elimination of this line on the Form.
<b>WRITTEN PROCEDURES— REMEDIAL REQUIREMENTS</b>	8038	Part VII, Line 43	This question asks if the “Issuer” has written procedures regarding remediation. Because this Form deals with conduit issues, whereby the ultimate obligor and user of the bond proceeds is the borrower, it may be appropriate to ask about procedures of the conduit borrower instead or in addition to the Issuer.
<b>WRITTEN PROCEDURES— SECTION 148</b>	8038	Part VII, Line 44	This question asks if the “Issuer” has written procedures regarding remediation. Because this Form deals with conduit issues, whereby the ultimate obligor and user of the bond proceeds is the borrower, it may be appropriate to ask about procedures of the conduit borrower instead or in addition to the Issuer.
<b>REIMBURSEMENT</b>	8038	Part VII, Lines 45a and b	These lines ask for the amount of bond proceeds used to reimburse prior expenditures and the date of the official intent action. It is possible that bond proceeds may be used to reimburse for “preliminary expenditures” or “de minimis expenditures;” as such, there would be no need to adopt an official intent resolution. If one enters an amount of preliminary expenditures that will be reimbursed on Line 45a without filling in a date for the official intent on Line 45b, there is an implication that an

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>VOLUME CAPS</b>	8038	Part VIII, Lines 47, 48 and 49a-d	<p>improper reimbursement has occurred. The Instructions or the Form needs to clarify and hopefully rectify this point. If the IRS is only interested in reimbursed expenditures requiring a declaration of intent, the Instructions could so state.</p> <p>What is the purpose of Line 47? To show a rolling count of the allocations made to date? Or does it contemplate a report as to the total allocation for the year? The former would require obtaining information from the central cap-allocating entity which may not be easy. The latter is theoretically possible in states which divide up the entire pot at the beginning of the year. However, if that is done, in Massachusetts at least, it is a tentative allocation which requires deal-specific approval during the year. We recommend eliminating this line.</p> <p>Line 47 seems to ask for a statement as to total volume cap allocated to the Issuer, which is not specific to the bond issue in question, since that is the subject of Line 48. However, the Form asks for attachment of the state certification, and the Instructions make clear that the certification is bond-specific, all the way down to CUSIP numbers. This requirement to attach a certification ought to relate to Line 48 instead.</p> <p>Line 47 refers to “state volume cap,” while Line 48 refers to “unified state volume cap.” Those who obsess about rules of construction might assume that the draftsman is drawing some sort of distinction. If Line 47 is not eliminated, if a distinction is being made, it should be explicitly defined. If not, we recommend conforming for consistency.</p> <p>The Instructions to Line 48 should make clear that it asks only about current-year cap. Carryforward cap is covered separately under Line 49 and 49b. Issuers think of deals which use carryforward allocations as being subject to the cap, but the Form treats it otherwise. The Instructions should be changed to be explicitly clear. Lines 48 plus 49 together should equal the issue price of the bond issue.</p> <p>If an issue is exempt from volume cap, then it will appear in Line 49, and one or more of its subparts a-d. If the transaction is entirely exempt from volume cap for one of these reasons, the Issuer presumably enters 0 in Line 48. Is there a good reason to require the Issuer in that case to enter something in Line 47? If so, it then is particularly important that the requirement for a deal-specific state certification to be part of Line 48, since no state certification will exist for the wholly exempt transaction, and the Instructions should be modified accordingly.</p>
<b>WEIGHTED AVERAGE MATURITY (WAM)</b>	8038-B	Part IV, Line 3	<p>Unlike the other Forms, the Instructions specify that WAM be entered to two decimal places of accuracy (hundredths of a year). For reasons not understood, the Instructions provide that the value be truncated not rounded. This Form also asks each digit to be separately entered in a box. This is</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
			unlike any of the other Forms that ask for similar information.
			We believe that asking for two decimal places of accuracy is needlessly burdensome. A year has approximately 365 days in it (though many calculations assume a 360 day year). Accordingly, the accuracy of .001 years is about three days. That degree of accuracy is hard to achieve because the weighting is by issue price, which may be only an approximation. One tenth of a year (think one month) is all the accuracy that should be required for proper administration of the tax law.
			We have no opinion about whether separate boxes should be provided for each digit. However, we see no reason why one Form should be different from the others.
<b>PAYMENT RECIPIENT</b>	8038-CP	Part I	It is very useful to provide a place for a recipient other than the bond Issuer. For Form consistency, it would make sense to have Part I match the other 8038 series Forms with the name and identification of the Issuer in Part I. Most of the time, the name of the recipient will be the same as the name of the Issuer. Rather than writing "same" for the name of the Issuer in Part II, the Issuer who is completing the Form could write "same" for the name of the recipient in a revised Part II.
<b>ISSUER</b>	8038-CP	Part II	We recommend reversing the order of Parts I and II to provide consistency with other Forms.
<b>CUSIP</b>	8038-CP	Part II, Line 14	It appears that the CUSIP number is used primarily to link Forms 8038-CP to a Form 8038-B, 8038-G, or 8038-TC filed for the bond issue. This is probably an inefficient method of linking. The Form 8038-CP could specifically ask which information Form (8038-B, 8038-G, and 8038-TC) was filed and what report number was assigned to it. However, because the IRS completes the report number, to fully link, the IRS should report back the list of report numbers. Alternatively, a common field could be created that would contain a short "nickname" for the issue. The same short name (say 12 characters maximum) should be used on all Forms relating to a single issue.
			We note that on Forms 8038-B and 8038-TC, the Instructions to the Forms for the corresponding field require attachment of a schedule of names, addresses, and EINs of bond purchasers. Such information may be useful for tax credit bonds for which the bondholder receives tax credits. It is not useful for all bonds (e.g., direct pay bonds) and appears to us to be collecting personal information at a high cost, which information is not relevant to the statistical analysis or administration of the tax law.
<b>NON ISSUER CONTACT</b>	8038-CP	Part II, Lines 15, 16	The Instructions to Form 8038-CP make it clear that by authorizing another entity to receive the payment, the Issuer is also authorizing the IRS to communicate directly with that entity. We believe that any such authorization should be limited in time. The Issuer should be able to enter an expiration date for such authorization. Indeed in the case of Form 8038-CP, which must be filed periodically,

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>TYPE OF ISSUE</b>	8038-CP	Part II, Line 17a	<p>the expiration should be automatic when a later Form 8038-CP is filed with a different recipient. We also believe that any authorization for such communications should be accompanied by a box to indicate that the Issuer requires copies of all communications made under such authorization. We also do not believe that this authorization should necessarily be tied to the recipient of the funds. Such authorization blocks are allowed on other 8038 series Forms. We anticipate that some Issuers would want to specify the name of a conduit borrower or an attorney or other professional. Indeed the most likely person to be so authorized is a paid preparer of the Form.</p> <p>For Build America Bonds, the types of issue mimic the types provided for on Forms 8038-G or 8038-B. However, on this Form only one type is to be checked; and that type is supposed to be the type that is the largest portion of the issue. It is unclear what advantage there is to the IRS in requesting this information. Such information was provided on the 8038-B or 8038-G filed for the issue. This item is asking the Issuer to collect information already available to the IRS. This information in no way affects the processing of the Form 8038-CP. It might be useful to Congress or Treasury to determine statistical information about how many credits are being claimed for each purpose. However, such a report could be compiled by comparing the Forms 8038-CP to the original information return. The information could also be useful to the IRS in determining whether to commence an examination of the issue, but again that is information already available. We see no way that it would affect the amount of the credit claimed or the eligibility of the Issuer to claim a credit.</p>
<b>ISSUE PRICE</b>	8038-CP	Part II, Line 17b	<p>The Instructions ask the Issuer to copy the issue price from the Forms 8038-B, 8038-G or 8038-TC filed for the issue. As with Type of Issue, this does not provide the IRS with any additional information. It is true that the issue price is important in determining if a bond issue qualifies for the credit. However, because the Issuer files this Form at least semiannually for the issue and the issue price does not change over time, providing this information repeatedly provides no additional benefit to the IRS. We would think that any challenge to the qualification of the issue based on issue price should be made by reference to the initial Form filed. We suppose that including the issue price on all Forms 8038-CP effectively is asking the Issuer to repeatedly recertify that the issue price reported the first time is correct. Later officers of the Issuer signing the Form 8038-CP could theoretically be prosecuted for perjury if the issue price turned out to be wrong. We note however, that after the passage of time, an officer signing the Form 8038-CP would have no independent knowledge to support the number initially reported as issue price. Any such attempt to prosecute such a later official for following the Instructions on the Form and copying the issue price from one Form to the other would not be successful. We suppose that issue price may also be used along with CUSIP and</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>VARIABLE OR FIXED RATE</b>	8038-CP	Part II, Line 17c	the name of the issue to tie back to a particular Form 8038-B or Form 8038-TC. However, such use seems redundant. Most taxable bonds have been sold with an issue price of Par. Therefore, for most Forms 8038-CP, the entry on Line 17b is the par amount of the bonds. We recommend elimination of this line.
<b>RECIPIENT NOT ISSUER</b>	8038-CP	Part III, Line 24	We believe it makes sense to ask whether the bonds for which the Form is submitted are fixed rate or variable rate. Unlike certain other information, this information could change over time. For example bonds that started out variable could be fixed. Line 17c should not be part of Part II relating to Reporting Authority. It should be moved to Part III Payment of Credit.
<b>CERTIFICATION OF ELIGIBILITY</b>	8038-CP	Not explicitly on Form	Form 8038-CP has a curiously-placed box to check to indicate whether the entity listed as the recipient (Part I) is the same as the Issuer. This box is totally superfluous. If the parties are the same, the Instructions tell the Issuer to write "SAME" on Line 7 and leave the rest of Part II blank (except for Lines 17a, b, and c none of which should be part of Part II and Lines 12, 13, and 14 which identify the issue). Asking the Issuer to check this box and asking for the word "SAME" on Line 7 increases the burden of completing the Form with no benefit.
<b>NON ISSUER CONTACT</b>	8038-G	Part I, Line 3(a)	We believe that the IRS position is that an Issuer completing Form 8038-CP is certifying that the bonds are in compliance with the requirements for the Issuer to claim the credit. We believe that if the IRS wants to take this position, the Form should explicitly state that the issuer is entitled to the credit claimed.
			The Instructions permit an Issuer to optionally enter the name, phone number, and address of a person who is not an employee or officer of the Issuer that the IRS can contact for more information. The opportunity to include such a name is potentially useful, but the circumstances surrounding it reduce its appeal. First, the Instructions make it clear that Line 4 should be the address of the non-employee listed on Line 3(a). This means that if a name is included on Line 3(a), there is then no place for the Issuer's own address. The implication is that all communication concerning the Form 8038-G, possibly including notification of a future examination, will either only be sent to the person indicated on Line 3(a) or possibly to a permanent address on file with the IRS. The problem is that for many issuers 8038 series Forms may be the only communication with the Internal Revenue Service. Without an address field for the Issuer, there may be no way to inform the Internal Revenue Service of the proper contact information.
			Also, for large Issuers, it is important that the address of contact be the address of Issuer personnel knowledgeable about tax advantaged bonds. Delivery of notices to any general address may cause important items to be lost or may cause significant delay. If an Issuer does determine to provide a



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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
			non employee name for this purpose, the authorization should be subject to an expiration date.
			There are a few different types of non-employees who might be appropriately entered on Line 3(a). The Form preparer, often an attorney may be appropriate. However, such professionals usually have a limited term engagement and will not represent the Issuer other than during a limited period. Because of this, most such attorneys would not permit their names to be used on an open ended authorization. A second type of non-employee contact person would be a bond trustee. However, a trustee is only going to be useful in this respect if documents tell the trustee how to respond. Again an expiration date would be useful. A third type of entry into this field is an officer of a conduit borrower. In such a case, it is important for the IRS to realize that the conduit borrower and the Issuer may have somewhat different interests. Many Issuers would make such an authorization only if the Issuer were copied on all materials sent to the conduit borrower. We would encourage the Internal Revenue Service to add to Line 3(a), in addition to an expiration date, a box to check for a copy of any communication to be sent directly to the Issuer.
<b>ADDRESS</b>	8038-G	Part I, Lines 4, 5, 6	The address field is used for both the address of the Issuer and the address of a non-Issuer contact. The same field should not be used for both purposes. An address for the Issuer should always be requested. A separate address field should be used for an optional non-Issuer contact.
<b>CUSIP NUMBER</b>	8038-G	Part I, Line 9	It appears that the CUSIP number is used primarily to link the Form 8038-T to an 8038, 8038-B, 8038-G, 8038-GC, or 8038-TC filed for the same bond issue. This is probably an inefficient method of linking. The Form 8038-T could specifically ask which information Form (8038, 8038-B, 8038-G, 8038-GC, 8038-TC) was filed. However, because the IRS completes the report number, to fully link, the IRS should report back the list of report numbers. Alternatively, a common field could be created that would contain a short "nickname" for the issue. The same short name (say 12 characters maximum) should be used on all Forms relating to a single issue.
			We note that on Forms 8038-B and 8038-TC, the Instructions to the Forms for the corresponding field required attachment of a schedule of names, addresses, and EINs of bond purchasers. Such information may be useful for tax credit bonds for which the bondholder receives tax credits. It is not useful for all bonds (e.g., direct pay bonds) and appears to us to be collecting personal information at a high cost, which information is not relevant to the statistical analysis or administration of the tax law.
<b>ISSUER CONTACT</b>	8038-G	Part I, Lines 10 a and b	We believe that it is important that all IRS communication about the bond issue be to the name listed in these fields. A street address should also be included for easy contact.
<b>TYPE OF ISSUE</b>	8038-G	Part II,	The Form 8038-G Instructions ask the Issuer to break down the issue into parts used for various

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
		Lines 11-18	<p>This serves a very useful purpose by allowing the Internal Revenue Service to collect statistical information about the purposes to which the tax subsidy is being applied. Unfortunately, the Instructions to various Forms use different definitions of “type of issue.” The type of issue on Form 8038-G might be education, but the type of issue on Form 8038 might be a qualified 501(c)(3) non-hospital bond. The lack of uniformity of meaning of “Type of Issue” means that when the information is requested on a Form 8038-T, for example, the words mean different things for different bond issues. We would suggest a common definition of “Type of Issue” be used consistently across all Forms. Where the IRS wants to use different categories of types, a different phrase should be used.</p>
<b>LIST OF USERS</b>	8038-G	Part II, Lines 11-18	<p>Although there is no field on the Form for the information, the Instructions to Form 8038-G require the attachment of a list of names and EINs of organizations that are to use the proceeds. This requirement may be very burdensome. The Instructions ask for the list of all users. This clearly cannot be meant to include users whose use is as a member of the general public. The substantive law on users is that certain use is not considered in determining private activity bond status. The instructions should clarify that only use that could affect the status of the bonds as governmental should be included. Often a full list of potential users is not known at the time of closing. Some bond issues have private users but are not private activity bonds because there is limited private payment and security. Assessment loan bonds also may have private users, though the tax law specifically creates an exception from the private loan test for such bond issues. A list of all property owners that front on a particular street may not be useful to a bond issue that is for public sidewalk improvements. When possible, the information requested should conform to the substantive law on private use. Use by organizations that would not affect the status of the bonds should not be collected. Also, de-minimis private use is allowed. Accordingly, users using a total of under 10% (5% for unrelated or disproportionate use) should not be requested in such a list. As a general matter, we think it would be better to create a Form or schedule on which to report this information so that all Issuers would report in the same format.</p>
<b>ISSUE PRICE</b>	8038-G	Part II, Lines 11-18, and Part III Lines 21(b), 23	<p>The Instructions refer to the regulations. Regulations in this area are very complex. Very often the Issuer may not know the exact issue price, but rather would know that the issue price was no higher than some amount. The reason for such lack of complete knowledge is that in publicly offered bond issues, the Issuer is not the party that makes the public offering and can only report what it has been told by bankers. In any case, knowledge by the IRS of the exact issue price of the bond issue is usually not relevant to the administration of the tax law and, of course, accuracy beyond \$10,000 is not important for statistical information. We recommend that the information on issue price be</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>ISSUE PRICE FOR TYPES OF ISSUE</b>	8038-G	Part II, Lines 11-18	<p>reportable as best available information. We think that the Instructions should explain that immaterial differences in reported issue price amounts from the actual issue price amounts, if not relevant for determining tax-exemption, should also not subject the Issuer or paid preparer to any sanctions.</p> <p>The Issuer is required under the Instructions to break the total issue price down by type of issue. For multi-purpose bond issues, this is a somewhat arbitrary task. An issue may have been approved for various municipal improvements including streets, street lighting, fire protection, and libraries. The exact amounts to be used for each purpose are often not determined prior to closing. Also, the categories are somewhat blurry. For example, street lighting definitely improves public safety, but also enhances transportation. Libraries may be educational, but they are not schools. Often Issuers are so confused by this that they lump all of the municipal purposes together and enter a mixed use under Line 18. That reduces the statistical benefits of this information request. We would suggest review of these categories and revise and/or consolidate consistent with current practices.</p> <p>Rather than requiring the issue price of each category to the nearest dollar, the IRS should find that the percent of the issue used for each purpose to the nearest 1% should be sufficient for all tax administration and statistical reporting purposes. The burden of reporting to the nearest dollar is far greater than any benefit to the IRS.</p>
<b>WEIGHTED AVERAGE MATURITY</b>	8038-G	Part III, Line 21(d)	<p>The Instructions are quite clear about how to calculate. No format or minimum accuracy is requested. This is appropriate given that calculated figures cannot have more accuracy than the inputs used to calculate them. We also note that as it relates to either the requirement that bonds not be left outstanding longer than necessary or to useful statistical information, any accuracy beyond tenths of years is irrelevant.</p>
<b>BOND YIELD</b>	8038-G	Part III, Line 21(e)	<p>There are many factors that can affect a computation of bond yield including the conventions used for the computation and the compounding interval used. The regulations do not specify what conventions to use or the compounding period. Therefore, when reported, the information is not particularly useful to the reader beyond the ability to distinguish between high yield and investment grade bonds. Any accuracy in the reported yield beyond two decimal places is irrelevant because a switch form monthly to semiannual compounding would have a greater effect, and compounding intervals are not reported. Also, variations in the issue price and other inputs may have an effect on yield in excess of the required 4 decimal places (e.g. 5.3125%) accuracy required by the regulations. We acknowledge that Treas. Reg. §1.148-4 does specify computations to 4 decimal places of accuracy. (We are not commenting on whether that regulation is sensible.) However, there is a big difference between a mandate that rebate and yield restriction compliance be determined to four</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>ACCRUED INTEREST</b>	8038-G	Part IV, Line 22	<p>decimal places and, requiring under penalties of perjury, that the yield be reported to that accuracy. A compliant computation may simply make a conservative estimate. The Instructions should allow conservative estimates and should only require one decimal place of accuracy (e.g. 5.3%). Nothing more accurate is useful in either reporting to congress or to the administration of the tax law. On actual examination of a bond issue for yield compliance, we would expect that the computations would be examined along with all assumptions about conventions and compounding intervals. That is not needed in information reporting.</p> <p>Treas. Regulation 1.148-1 defines proceeds to exclude “Pre-issuance accrued interest.” Although the modifier “Pre-issuance” is not used on Line 22 or in the Instructions for that line, we believe that accrued interest is intended to have that meaning. (Pre-issuance accrued interest does not include more than one year’s worth of accrued interest, but virtually no municipal bond issues are structured with more than one year’s worth of interest. Pre-issuance accrued interest also must be payable within one year, but accrued interest is always payable on the first interest payment of a bond issue. If the period before the first interest payment date was more than one year (which happens), the interest payment would not be qualified stated interest and the bond would be an Original Issue Discount “OID” bond. We believe that in such a case, nothing should be treated as accrued interest.) Any accrued interest at all on tax-exempt bond issues has become rare. Most bonds are dated the date of closing. Given that accrued interest rarely exists and, if it does exist is carved out of sale proceeds (and hence out of proceeds), we believe that this line item should be eliminated. Accrued interest should simply not be included in the total amount of proceeds. This suggested change would also make the arithmetic of the Form simpler.</p>
<b>GUARANTEED INVESTMENT CONTRACT (GIC) INVESTMENT</b>	8038-G	Part VI, Line 36(a)	<p>We note that the Instructions and the Form ask for the amount of gross proceeds to be invested in a GIC. We note that some gross proceeds are not subject to either yield restriction or to rebate. For example, gross proceeds in a bona fide debt service fund may be exempt from arbitrage restrictions. We see no advantage to the IRS in collecting this information. In fact, it may be very misleading. If an Issuer enters into a 20 year GIC on its bona fide debt service fund, then the amount of gross proceeds invested in the GIC may in total exceed the size of the bond issue. On the other hand, the maximum amount that will ever be invested is a much lower number. (Money will be invested and returned every year.) We think that the burden of this question would be greatly reduced and the usefulness of the information greatly enhanced if the question was limited to gross proceeds subject to rebate or yield restriction. Obviously, information about the investment of gross proceeds, not subject to arbitrage restrictions, cannot aid in the administration of the arbitrage rules. In fact, it might cause IRS examine bond issues for no reason creating a misapplication of resources. Finally,</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>GIC INVESTMENT</b>	8038-G	Part VI, Line 36(b)	we note that the Instructions do not distinguish between investments made at closing and those entered into post closing. All an Issuer can do, with respect to future investment, is to report what it expects at closing. Such expectations may not be particularly useful to IRS. A better approach is to limit the request to GICs executed at or prior to the filing of the Form.
<b>GIC PROVIDER</b>	8038-G	Part VI, Line 36(c)	There may be more than one GIC for proceeds of an issue. Asking for the final maturity date of the GIC appears to be asking for the maturity date of the longest running GIC. The Instructions should clarify what information is required.
<b>POOLED FINANCING</b>	8038-G	Part VI, Line 37	We do not know why the name of the GIC provider is requested. Issuers ask if there are providers to be avoided. Is a particular GIC provider likely to trigger an examination? Particularly because the names of the GIC providers are not always the same as the guarantor of the GIC, these names may have limited value in enforcement. We do not think that the name provides any meaningful statistical information and would suggest eliminating this question from the Form.
			The Instructions require this line to be completed even for bond issues in which the proceeds are lent to a single user. We noted, however, that IRS used this line to classify a bond issue for examination as a pooled financing subject to Code Section 149(f). We believe the Instructions to the Form should conform to the wording on the Form and that this information should only be collected for bond issues making loans to two or more borrowers. Furthermore, the other requirements of Section 149(f) should also apply to determining if a response is warranted. For example, Code Section 149(f) does not apply if less than \$5,000,000 is lent to two or more entities. Loans do not include, for purposes of Code Section 149(f), use of proceeds by an agency of the Issuer.
			Some bond issues that are properly treated as pooled financings under Code Section 149(f) nevertheless are unlikely to exhibit concerns attributed to pooled financings. These are bond issues that are payable from sources other than the repayments by the borrowers. It would be appropriate to ask if the Issuer of the pooled financing bonds was obliged to repay the bonds from a source other than loan repayments. To the extent that this question is used for classification purposes, such an additional question would permit distinction among pooled financings at relatively little burden.
<b>BANK QUALIFICATION</b>	8038-G	Part VI, Line 39	This line is in the form of a single check box. We note that some issues are only partially designated. Others are "deemed designated" in whole or in part. The Instructions should clarify that this box should be checked if any bonds of the issue are designated. It might be useful to ask the box to be checked for bank qualified bonds that are deemed designated even if not designated.
<b>IDENTIFIED HEDGE</b>	8038-G	Part VI, Line 41	Hedge information is very specific to a transaction. We believe that the Instructions make it clear that information should only be entered for qualified hedges. We are unsure about the IRS use of the

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
			name of the hedge provider. The term of the hedge provides one piece of financial information, but it is not of great use without more details about the hedge. Many hedges are terminated on issuance of the bonds. It is unclear what the term of such a terminated hedge should be. Type of hedge is requested, but there is no uniform method of categorizing hedges. Generally, we believe that the information collected is not well considered and that the usefulness of the information is not well established.
<b>SUPERINTEGRATED HEDGE</b>	8038-G	Part VI, Line 42	The Issuer is already required to report whether the bond issue is a fixed yield bond issue or a variable yield bond issue. (Line 21(e)). If there is a qualified hedge and the issue is fixed yield then it is a super integrated hedge. If the issue is variable yield then it cannot be a super integrated hedge. The question provides no additional information. It should be deleted.
<b>WRITTEN PROCEDURES FOR PRIVATE ACTIVITY REMEDATION</b>	8038-G	Part VI, Line 43	We agree that written procedures are useful and should be encouraged. The particular question seems to put the horse before the cart. The Form does not ask if there are written procedures to avoid private use problems, only whether there are procedures to deal with violations. Perhaps written procedures should be reported in more detail.
<b>REIMBURSEMENT</b>	8038-G	Part VI, Line 45	Asking about reimbursement is appropriate. However, the question needs some reworking. First, the amount of reimbursement is often not known at closing. Money may be deposited into a project fund and then the Issuer may determine that some portion of the project fund be allocated to reimbursed expenditures. The amount should be an estimate only. Many reimbursement allocations (including de-minimis amounts and preliminary expenditures and also working capital expenditures) do not require reimbursement declarations of intent. As currently drafted, the question appears to assume that all reimbursed expenditures must be within the scope of a declaration of intent. The Instructions say very little on this point. The Instructions should make it clear that Line 45(b) need only be completed if an official declaration of intent was required.
<b>NON-GOVERNMENT CONTACT</b>	8038-GC	Not provided for	It is quite common for Form 8038-GC to be completed and even filed by a non-government person (often the purchaser of the debt). We believe that the reporting authority information for Form 8038-GC should be the same as for Form 8038-G.
<b>CONTACT NAME</b>	8038-GC	Part I, Line 6	At the end of the Instructions, there is a Note that indicates a non-employee may be entered on Line 6. We recommend use of a uniform contact system as described in our report.
<b>AMOUNTS</b>	8038-GC	Line 9	We believe asking to the nearest dollar is excessive. Asking a percentage to the nearest percent makes more sense.
<b>BANK QUALIFIED</b>	8038-GC	Line 10	We are pleased that the Form recognizes that some, but not all, bonds may be designated. We believe

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>DESIGNATION</b>			that the reference should, however, be to “any bonds” rather than any issue since in some cases some bonds of an issue may be designated.
<b>VENDOR OR BANK</b>	8038-GC	Part II, Lines 12 and 13	In effect, the Form 8038-GC (unlike any of the other Forms for tax-exempt bonds) asks for the bond purchaser to be identified by name and taxpayer I.D. We believe that collecting this information is intrusive and may serve little purpose.
<b>ADDRESS</b>	8038-R	Part I, Line 3	Unlike the address field on the Form 8038-G, this appears to request the Issuer’s Address.
<b>CUSIP</b>	8038-R	Part I, Line 8	It appears that the CUSIP number is used primarily to link Forms 8038-R and 8038-T to an 8038, 8038-B, 8038-G, 8038-GC, or 8038-TC filed for the same bond issue. This is probably an inefficient method of linking. The Form 8038-T could specifically ask which information Form (8038, 8038-B, 8038-G, 8038-GC, 8038-TC) was filed and what report number was assigned to it. However, because the IRS completes the report number, to fully link, the IRS should report back the list of report numbers. Alternatively, a common field could be created that would contain a short “nickname” for the issue. The same short name (say 12 characters maximum) should be used on all Forms relating to a single issue.
			We note that on Forms 8038-B and 8038-TC, the Instructions to the Forms for the corresponding field required attachment of a schedule of names, addresses, and EINs of bond purchasers. Such information may be useful for tax credit bonds for which the bondholder receives tax credits. It is not useful for all bonds (e.g., direct pay bonds) and appears to us to be collecting personal information at a high cost, which information is not relevant to the statistical analysis or administration of the tax law.
<b>CONTACT</b>	8038-R	Part I, Line 9	Unlike the Form 8038-G, a single field is used for either a contact at the Issuer or a contact who is not an officer of the Issuer. We believe that most Issuers will complete this field with an officer or employee of the Issuer. We believe that if IRS wants to encourage the use of outside contacts, it must create a more explicit method of authorization. As described in reference to the Form 8038-G, the Form should include an expiration date for the outside contact as well as a box to check for copies of all correspondence to be given to the Issuer as well as the outside contact.
<b>NON GOVERNMENTAL USER</b>	8038-R	Part III, Line 21	Form 8038-R has an explicit field for providing the name and contact for a non-governmental conduit borrower. We do not understand why the field is limited to non-governmental conduit borrowers. There are transactions with governmental borrowers. However, we are very pleased with the existence of this field because it recognizes that for some purposes a conduit borrower is the appropriate party for contact. As with the requirement to list names and EINs for users of proceeds of

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>CONDUIT CONTACT</b>	8038-R	Part III, Line 22	governmental bonds on Form 8038-G, we believe that this field should be limited to non-de-minimis users whose use is relevant to the private use analysis. The Issuer may not know the EIN of every user of bond proceeds including those that use minor amounts of bond financed property. Additionally, Form 8038-R concerns rebate. Unless the private user actually had control over the investment of proceeds of the bonds, the identity of such user of bond financed property is irrelevant to the purposes of Form 8038-R. Perhaps the Instructions should clarify that use of bond financed facilities, after bond proceeds are spent, does not cause the person to “use proceeds.”
<b>CUSIP NUMBER</b>	8038-T	Part I, Line 8	Form 8038-R explicitly allows the designation of a contact representative of the conduit borrower. However, all of the concepts, applicable to any non-Issuer contact, also applies in this case. Thus, we think that the Form should allow the Issuer to request a copy of all communications and should be able to specify an expiration date for such authorized contact.  It appears that the CUSIP number is used primarily to link the Form 8038-T to an 8038, 8038-B, 8038-G, 8038-GC, or 8038-TC filed for the same bond issue. This is probably an inefficient method of linking. The Form 8038-T could specifically ask which information Form (8038, 8038-B, 8038-G, 8038-GC, 8038-TC) was filed. However, because the IRS completes the report number, to fully link, the IRS should report back the list of report numbers. Alternatively, a common field could be created that would contain a short “nickname” for the issue. The same short name (say 12 characters maximum) should be used on all Forms relating to a single issue. CUSIP could be used, but if so, only the originally assigned CUSIP should be used. If a newly assigned CUSIP is used, linkage will not be accomplished.  We note that on Forms 8038-B and 8038-TC, the Instructions to the Forms for the corresponding field required attachment of a schedule of names, addresses, and EINs of bond purchasers. Such information may be useful for tax credit bonds for which the bondholder receives tax credits. It is not useful for all bonds (e.g., direct pay bonds) and appears to us to be collecting personal information at a high cost, which information is not relevant to the statistical analysis or administration of the tax law.
<b>TYPE OF ISSUE</b>	8038-T	Part I, Line 11	Type of issue has various meanings on different forms. We believe that there are too many types for the data to be useful. Particularly for bonds reported on Form 8038-G, the categories are overlapping. Often more than one category applies. Perhaps the type of bond should be limited to “governmental purpose” bonds for non-private activity bonds.
<b>ISSUE PRICE</b>	8038-T	Part I, Line 11	Issue price is a complicated concept. Tax law has created an environment where issue price may be unknown to the nearest dollar. We believe that the Instructions should make it clear that a maximum



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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>COMPUTATION DATE</b>	8038-T	Part II, Line 12	issue price may be used on the Form in cases where the actual price is unclear.  We note that Issuers may make yield reduction payments or rebate payments in anticipation of liability. In such cases, a future computation date may apply. We would encourage instructions that specifically allowed such future dates.
			Yield reduction payments on student loans (or where permitted on other purpose investments) should be reportable separately from payment on non-purpose investments, since under the regulations they are not interchangeable.
<b>PENALTY IN LIEU</b>	8038-T	Part III	Penalty in lieu of arbitrage rebate. We note that this section is used very infrequently, and is using a large amount of space on the Form for very little benefit.
<b>WAIVER OF PENALTY</b>	8038-T	Part III, Line 20	The Issuer will ordinarily check the “yes” box that the conditions are satisfied. In fact, IRS determines if conditions for the penalty waiver are satisfied and hence the question is somewhat unfair to ask. IRS could ask “Do you wish to be considered for penalty waiver?” Instructions could make it clear that that box should only be checked if the Issuer believes itself to be eligible.
<b>MISCELLANEOUS</b>	8038-T	Part VI	Many of these questions are not helpful in determining if the correct payment is being made. The statistical analysis benefit of some entries is suspect.
<b>UNSPENT PROCEEDS</b>	8038-T	Part VI, Line 24	Unspent proceeds can be a very complicated amount to calculate. We note that for a similar question on Form 990, Schedule K (Part II Line 12) amounts in refunding escrows are to be excluded from the unspent proceeds amount. It would be appropriate to make the same exclusion here. Unspent proceeds generally fall into three categories: project fund moneys, reserve fund moneys, and refunding escrows. Although the Instructions may be unclear, the amount of unspent proceeds to be entered appears to be as of the computation date for which the Form 8038-T is being filed. Even if refunding escrows are eliminated from this request, it is sometimes complicated to value the investments containing unspent proceeds. Note, that it is generally not necessary to obtain a market value for these investments as of the computation date. Instructions should clarify, that for this purpose, investments can be valued at any of fair market value, present value, par plus accrued interest (for plain par investments), or investment carrying value as shown in bank or brokerage statements.
			We strongly suggest following the approach of the Schedule K with respect to refunding escrows because amounts in refunding escrows are generally not actively invested or managed. The Form 8038 or 8038-G already indicates the date an advance refunding escrow will terminate. There is little benefit to the IRS in requesting the value of the refunding escrow investments.

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>QUALIFIED ADMINISTRATIVE COSTS</b>	8038-T	Part VI, Line 26	The amount of qualified administrative costs paid for guaranteed investment contracts may be relevant to the rebate amount if the GIC in question holds funds subject to rebate. Otherwise, it is irrelevant. For example, amounts paid for GICs per bona fide debt service funds are often irrelevant. In terms of statistical information, the category may be too broad. It might be useful to report to Congress how much is paid for refunding escrows, because that might indicate if the SLGS program is properly functioning. Similarly, the amount spent to broker reserve fund GICs might be relevant. The broad categories, however, make that highly suspect.
<b>HEDGE PROVIDER</b>	8038-T	Part VI, Line 29	We don't believe that the name of hedge provider is relevant for any purposes. It is similar to the name of a guarantor (not required on Line 27).
<b>NAME OF GIC PROVIDER</b>	8038-T	Part VI, Line 30	We see this as an unnecessary gathering of information, neither useful for the administration of arbitrage rebate, nor to compiling statistically useful information.
<b>BEYOND TEMPORARY PERIOD</b>	8038-T	Part VI, Line 31	The information desired is likely whether any non-purpose investments were subject to yield restriction. That would be a better way to ask the question. If funds are in a reasonable reserve, are they invested beyond a temporary period? Theoretically amounts in an advance refunding escrow are eligible for a thirty day temporary period. Accordingly refunding escrow amounts trigger a yes response. In fact, what is useful information is whether project fund moneys remained after the expiration of the three year (or five year) temporary period. The question should be restricted to project fund amounts. For example, suppose that a bond issue had both a project and an advance refunding component. As presently designed, the box would be checked yes even if the project fund and the escrow were both fully expended in two years. Checking the box should be an indication that a separate yield reduction payment calculation is required. As currently formulated, the Form does not distinguish between amounts subject to a yield reduction payment and those that are not.
<b>PAID PREPARER</b>	8038-T	Part VI, Line 32	We believe that the inclusion of a paid preparer block obviates the need for a question concerning whether the computations were prepared by the user or a preparer. We believe that if a preparer does the computation, it should ordinarily sign as paid preparer. Line 32 is a holdover from before the inclusion of the paid preparer block and should be eliminated.
<b>ESTIMATED PAYMENT</b>	8038-T	New Line	We believe that Form 8038-T should specifically allow an estimated payment to be made. Often a bond issuer will realize that it owes rebate or yield restriction payments, but cannot timely complete Form 8038-T. Form 8038-T should include a check box. If checked: (1) the amount paid will be considered an estimate; (2) other information may be omitted if unknown; and (3) an amended and complete return will be required in 90 days (or whatever period of time appears reasonable).
<b>THIRD PARTY</b>	8038-TC	Part I, Line	IRS is offering Issuers the ability to specify a person other than an officer of the Issuer who may be

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Description	Form	Location in Form	Comment
COMMUNICATION		3	<p>available to answer questions. On the Form 8038-TC, this line is distinct from Line 10, which asks for the name of an officer who may be available to answer questions. Line 11 provides a phone number for either the representative identified in Line 3 or the officer identified in Line 10. (This may be confusing when Line 10 is blank.) Contrast this to Form 8038-T Line 9, which provides for a name and title of an officer or other person identified for this purpose. Since the Instructions for Form 8038-TC clearly state that Line 10 should be left blank if Line 3 is complete, only one name is to be provided. A better more consistent format for this information is to use the formulation on the Form 8038-T with only one blank to be completed and no blanks required to be left blank. Because it may be useful for IRS to know if the person identified is an officer or employee of the Issuer, a set of check boxes could be used to elicit this information. We see the following possible responses: (1) an officer; (2) an employee of the Issuer; (3) an employee of a conduit borrower; (4) the paid preparer of the Form; and (5) another professional. In practice, we believe that the use of a person other than an employee of the Issuer or conduit borrower will not be common. The authorization is so open ended that professionals may be reluctant to agree to use of their names. Assuming that this contact will only be made within a short period after the Form is filed, we think it useful and appropriate to modify the signature block to indicate that such authorization will automatically expire 90 days after the Form is filed.</p>
CUSIP	8038-TC	Part I, Line 9	<p>The primary purpose of collecting the CUSIP number is to clearly identify the bond issue in a unique fashion. When CUSIPs exist, they can be used to cross reference a great deal of information on the issue including the MSRB data presented on its EMMA website. A secondary purpose for tax credit bonds may be to aid the tracking of tax credits claimed by bond holders (or purchasers of stripped credits). Where bonds are privately placed or where there is no CUSIP, the Instructions require the provision of a list of purchasers including names, addresses, and Employer I.D. numbers. We believe that this is overly intrusive and provides the IRS with little benefit in terms of statistical compilations or the aiding of enforcement. Particularly for direct pay tax credit bonds, there can be no enforcement benefit. Bondholders receive no tax benefit and therefore would be unlikely to be contacted in an examination of the Bonds. Such bondholders would be unlikely to have any information relevant to the examination. Often such bonds are purchased by foreign investors who are not required to obtain EINs and in fact do not have EINs. At a minimum, any reference to EINs should be to TINs to allow other types of TINs to be used. However, we believe that if no CUSIP is available, a simple short code, uniquely identifying the bond issue, could be inserted. Collecting data on bondholders does not serve any purpose commensurate with the intrusiveness of the question. Note also that the Instructions require the bondholder list even if a CUSIP is provided if the bonds are sold in a private placement. If a CUSIP exists and has been provided, nothing further should be</p>

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
			needed or expected by the IRS. We believe that the best approach is to separate the Stripped Credit administration questions from the identification questions. One CUSIP number is sufficient to identify the issue. If the bond issue is an issue of direct pay bonds, no further bondholder or CUSIP information should be required. If the bond issue is an issue of tax credit bonds, but the credits are not expected to be stripped, again, no additional bond owner information or CUSIP information is needed. However, if tax credits are expected to be stripped, Form 8038-TC would appropriately ask for such additional bond owner identification and CUSIP information. Rather than having such information entered as part of Part I (Reporting Authority), we think such information should be requested on a separate schedule to be attached to any bond issue if tax credits are to be separated from the bond.
<b>TYPE OF ISSUE</b>	8038-TC	Part II	Type of Issue in this context is very different from Type of Issue on other Forms. Perhaps the heading of Part II should be changed to reflect the Type of Tax Credit Bonds.
<b>CREDIT BOND CODE</b>	8038-TC	Part II, Line 1	A numeric Code for the type of tax credit may be simpler to use than the formats on Forms 8038 or 8038-G. A similar numeric code could be used on Form 8038 to indicate whether the bond was a 501(c)(3) bond, a small Issuer manufacturing bond, a mortgage revenue bond, or an exempt facility bond, and if an exempt facility bond, which exempt facility.
<b>DESCRIPTION</b>	8038-TC	Part II, Line 2	This seems a bit repetitive of the information elicited from the credit bond code. The Instructions say “enter type of bond.” This appears to be a reference to the type of tax credit bond used to enter the code in Line 1. Because the type of projects for which each type of tax credit bond can be issued is limited, it is unnecessary to identify the specific subcategory of the issue type. Additionally, Part V asks for very specific information on the use of proceeds.
<b>IRREVOCABLE ELECTION</b>	8038-TC	Part II, Line 3	This information is helpful for the IRS to identify whether the direct pay specified tax credit bond election has been made. This is different from the 8038-B, which does not ask whether the Issuer has made an irrevocable election, but rather asks the Issuer to check one of three boxes identifying Build America Bonds (direct payment), Build America Bonds (tax credit) or Recovery Zone Economic Development Bonds (direct payment). If an Issuer has not made the election, the Issuer does not need to fill out the first interest payment date or the interest payment date frequency. This limitation recognizes that the principal purpose of the interest payment date questions relate to Form 8038-CP filings, not required for bond holder tax credit bonds.
<b>ISSUE PRICE</b>	8038-TC	Part III, Line 1	Issue price is a complicated concept. Tax law has created an environment where issue price may be unknown to the nearest dollar. We believe that the Instructions should make it clear that a maximum issue price may be used on the Form in cases where the actual price is unclear.

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>FINAL MATURITY DATE</b>	8038-TC	Part III, Line 3	Requires the attachment of each principal payment date if there is more than one maturity. On a fixed rate bond, this would be repetitive of information on the Fixed-Rate Bond Debt Service Schedule
<b>APPLICABLE CREDIT RATE</b>	8038-TC	Part III, Line 4	This line is required to be carried out to 2 decimal places without rounding. Because this is a rate published by the United States Treasury, the concept of rounding and places does not seem appropriate. No calculation is required to determine the rate. What would seem appropriate, but is not requested, would be for the Issuer to provide the date used to determine the rate. (Generally the Sale Date of the Issue.)
<b>MAXIMUM TERM</b>	8038-TC	Part III, Line 5	The maximum term is to be carried out to 2 decimal places with zeroes in the last 2 positions without rounding. However, zeroes are to be added to the last 2 positions. The maximum term is always a whole number and is published but the United States Treasury. The date used to determine the maximum term would be an appropriate question.
<b>PERMITTED SINKING FUND YIELD</b>	8038-TC	Part III, Line 6	The applicable maximum permitted yield is to be carried out to 4 decimal places without rounding, but zeroes should be added in the last 2 places. There is never an opportunity to round because the sinking fund yields are published to 2 decimal places. The date used to make the determination would be appropriate to ask.
<b>INTEREST RATE ON THE BONDS</b>	8038-TC	Part III, Line 7	This information allows the IRS to apply the limitation of direct payments to the actual interest payable on the bonds. However, for issues with serial maturities, the Issuer is supposed to enter the interest rate of the latest maturity. Thus, this rate alone will not always be sufficient to determine the maximum credit amount. For purposes of determining the maximum subsidy amount, rates on all bonds of the issue could be included on required debt service schedules to be attached. The interest rate of the final maturity may also be useful for statistical purposes. However, we note that while earlier versions of Forms 8038-G and 8038 did ask for information about the final maturity, those questions were eliminated some time ago. We presume that the IRS determined that there was little statistical benefit to asking questions about the final maturity. This may be an example of a request for information that is more burdensome than valuable.
<b>PROCEEDS OF ISSUE</b>	8038-TC	Part IV	The organization of Part IV of Form 8038-TC is complex, confusing, and error causing. Sale Proceeds should equal Issue Price. Estimated investment proceeds also represent proceeds. Generally, the sum of these two will encompass proceeds. If desired a third line for "other proceeds" could be included (but if so, it would almost always be blank). As currently organized, uses of proceeds are provided in Lines 2, 4, 5 (never to be used) and 6. As currently organized, Line 7 is the total of Lines 4, 5 and 6, that is all proceeds other than those used for costs of issuance. A total including costs of issuance makes more sense. In general the format of Forms 8038-G and 8038, in

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
			capturing the same information, make much more sense. For consistency sake, as well as ease of understanding, Part IV of Form 8038-TC should be replaced with lines similar to Part IV of Form 8038-G. However, it would make sense to add lines for the estimated investment earnings if IRS believes that the expected amount of investment earnings would aid in the administration of tax law or that it would provide useful statistics.
<b>SALE PROCEEDS</b>	8038-TC	Part IV, Line 1	In the case where issue price may not be known with certainty, an Issuer should be permitted to enter a maximum sale proceeds amount. Also, Instructions correctly indicate that if bonds are stripped at the issuance, the sale proceeds, of the strips, and principal should be included.
<b>ESTIMATED INVESTMENT EARNINGS</b>	8038-TC	Part IV, Line 3	Requiring an estimate of investment earnings is not required on all information reporting Forms. It would be helpful for investment earnings to be consistently requested on all 8038 series Forms.
<b>EXPECTED AVAILABLE PROJECT PROCEEDS</b>	8038-TC	Part IV, Line 4	Available project proceeds are equal to the subtraction of Line 2 from Line 1, and the addition of Line 3. The purpose of this cannot be to collect information, but must rather be to alert the Issuer that there are restrictions on the use of proceeds. We believe it could be omitted.
<b>MATCHING PLEDGED FUNDS</b>	8038-TC	Part IV, Line 5	This is for Midwestern tax credit bonds, which can no longer be issued. This should be removed. This also may be confusing to Issuers of Qualified Zone Academy Bonds, who may think it relates to the private business contribution requirement. In any case, the line is for a subcategory of bond proceeds and, therefore, should not be used for an amount other than proceeds.
<b>OTHER PROCEEDS</b>	8038-TC	Part IV, Line 6	The Instructions say enter any other amount of proceeds. This line will ordinarily be left blank because almost by definition, Lines 2 and 4 add to total proceeds.
<b>TOTAL PROCEEDS</b>	8038-TC	Part IV, Line 7	The required calculation does not match the description. Adding expected available project proceeds to two other lines that will generally be zero does not equal "total proceeds" because "total proceeds" should also include amounts used for costs of issuance.
<b>PERCENTAGE OF TOTAL PROCEEDS TO BE USED FOR QUALIFIED PURPOSE EXPENDITURES</b>	8038-TC	Part V, Line 15	The Issuer is required to calculate an estimate of the percentage used for a qualified purpose. The Code and Regulations generally require all of the available project proceeds to be used for qualified purposes. Thus, the only reason for this question to be included on Form 8038-TC is to alert the Issuer of the limitation. Because the Form asks for a number, many Issuers may mistakenly think that they must be misreading the Form. The question should be eliminated.
<b>DATE OF OFFICIAL INTENT</b>	8038-TC	Part V, Line 17	There may be more than one official intent adopted, so the Instructions should be clear that the schedule should be attached. Also, not every reimbursement requires a reimbursement declaration of

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
PART VI, ALLOCATION OF VOLUME CAP	8038-TC	Part VI	intent. We recommend expanding this section to provide for multiple adoption dates. Instructions should make it clear that if reimbursements do not require a declaration of intent, then the line may be left blank.
CHECK BOXES FOR NATIONAL V. LOCAL V. TRIBAL	8038-TC	Part VI	Issuer is required to attach the copy of the allocation certification. What is the IRS going to do with the attached certification? The attachment will not aid in collecting statistical information. It has limited value in classifying issues for examination. So long as an Issuer knows that it will be required to produce the certification in the event of an examination, there is little to be gained by requiring the certification to be included.
ARBITRAGE QUESTIONS	8038-TC	Part VI, Line 1(b), (c) and (d)  Part VII, Line 1	Issuers may be confused as far as when to check national vs. local vs. state for volume cap purposes. The Instructions should spell out what volume cap options are available for each type of issue.
RESERVE OR SINKING FUND EXPECTED TO REPAY ISSUE (CHECK BOX)	8038-TC	Part VII, Line 1(a)	We understand the usefulness of asking whether a reserve fund (or invested sinking fund) exists. Such question could assist in the classification of bond issues for examination, and could provide statistically useful information. The question about written procedures is appropriate. The remaining questions appear to be included for the purpose of reminding Issuers of the applicable rules. That is unnecessary. The applicable rules are actually more complicated than would appear from the Form 8038-TC.
IF YES, CHECK BOX IF FUNDED IN EQUAL PERIODIC INSTALLMENTS	8038-TC	Part VII, Line 1(b)	It is appropriate to ask whether a sinking fund has been established and do not recommend changes to this line.
IS RESERVE/ SINKING FUND MORE THAN NECESSARY TO PAY BONDS OR YIELD GREATER THAN	8038-TC	Part VII, Line 1(c)	This should say is structured (or expected to be) to be funded in equal periodic installments because it goes to the future funding of the reserve/sinking fund. The question does not track the Code in that the Code requirement is funding no faster than equal annual installments. Slower funding could require the box to be checked. The question is more burdensome than beneficial; and we recommend this line be eliminated from the Form.

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
THE PERMITTED SINKING FUND YIELD, CHECK BOX			
CHECK BOX IF WRITTEN PROCEDURES ARE ESTABLISHED TO COMPLY WITH ARBITRAGE	8038-TC	Part VII, Line 1(d)	The Instructions should make clear what constitutes written procedures by a reference to the IRM.
CHECK BOX IF ALL FEDERAL, STATE AND LOCAL REQUIREMENTS GOVERNING CONFLICTS OF INTEREST ARE SATISFIED	8038-TC	Part VII, Line 2	Code Section 54A(6) requires the Issuer of qualified tax credit bonds to certify that all applicable state and local law requirements governing conflicts of interest are satisfied with respect to the issue. Certification on Form 8038-TC should satisfy this requirement. There is little guidance about what conflict of interest rules may be applicable to such bonds. Furthermore, the Form requires certification concerning federal conflict of interest rules as well, although the Code is more restrictive, applying only to rules concerning members of Congress, federal, state, and local officials and their spouses, and then only if the Secretary of the Treasury prescribes additional rules. While such certification is required, the official certifying may need lengthy education on just what the certification means. It would be best to word the requirement as narrowly as possible. It would also be useful to explicitly state in the Instructions that applicable conflict of interest rules only relate to rules governing contact with public officials involved with the issuance of the bonds. Because this is a certification of the Issuer, it should not be interpreted to cover conflict of interest violations by third parties (e.g., tax practitioners).
CHECK BOX IF CREDITS ARE EXPECTED TO BE STRIPPED	8038-TC	Part VII, Line 3	For tax credit bonds, it is appropriate for the Form to request information concerning the stripping of credits because the IRS needs to administer the application of such credits. Note, that if this box is checked, additional information including all CUSIP numbers is required currently under Line 9 of Part I. However, we view this use of CUSIP information as very different from the identification purposes of Part I. We have provided an alternative Form of Part I to be used on all 8038 series Forms. The questions used in the administration of stripped credits should be moved to Part VII (or a separate schedule to be attached for bonds with stripped credits).
CONSENT TO PUBLISH	8038-TC	Part VIII	This extra signature block at the end of Form 8038-TC is confusing. Many Issuers accidentally sign this block rather than the earlier block for the Form itself. We do not believe this extra block (not applicable to direct pay bonds) serves any useful purpose. It is unclear to us what action IRS would take if the "No" Box were checked. The confusing nature of the question applies even to direct pay



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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
<b>CUSIP</b>	990, Schedule K	Part I, Column C	bonds because of its positioning.  In the Instructions, the borrower is only asked to provide the CUSIP on the bond with the latest maturity and should be identical to the CUSIP on the 8038 filed for the respective issue. What is the information used for? For example, when a partial defeasance or remedial defeasance occurs of the last serial maturity, the borrower is required to obtain two new CUSIPs: one for the defeased portion and one for the non-defeased portion.
<b>ISSUE PRICE</b>	990, Schedule K	Part I, Column E	The issue price is generally obtained from the 8038 filed with the respective bond issue. There are several opinions regarding the correct computation of "Issue Price." See discussion on other Forms regarding this topic.
<b>GROSS PROCEEDS</b>	990, Schedule K	Part II, Line 4	This line requests the borrower enter the amount of gross proceeds held in a reserve fund, sinking fund, etc. By definition, gross proceeds include investment earnings. Is this a cumulative number as implied by gross proceeds or market value as of the related fund as of the last day of the reporting period? The compilation of aggregate investment earnings are transferred to bond principal and interest funds and netted against the scheduled net debt service payments may rise to the level of more cost than benefit obtained.
<b>PROCEEDS</b>	990, Schedule K	Part II, Line 10	Is this amount only related to new money issues or refunded issues as well? If it includes refunded issues, should this figure correspond to the 8038 of the bonds that were refunded? The Instructions should clarify.
<b>PROCEEDS</b>	990, Schedule K	Part II, Line 13	What should be used when a project fund has been depleted, but there are still significant expenditures that will be funded through equity? Should the last project expected to be placed in service be used consistent with the expected placed in service date of the corresponding Tax Agreement? We suggest the Instructions so clarify.
<b>PRIVATE BUSINESS USE</b>	990, Schedule K	Part III, Line 2	Are aggregate leases under the 5% threshold, to be included? If so, perhaps the Instructions for this section should be expanded similar to Instructions for Part III, Line 3a.
<b>PRIVATE BUSINESS USE</b>	990, Schedule K	Part III, Line 4	Large organizations that borrow for multiple entities expend substantial amounts of time and resources in order to track the use of its bond financed properties in an effort to ensure its bonds remain tax-exempt and qualify for self-correcting remediation within 90 days of deliberate action(s). Although tracked, to require an identified percentage, even though less than the permitted 5%, might unintentionally subject the borrower to inaccurate reporting if small arrangements were unidentified. It should also be made clear this amount does not include proceeds that have been remediated.
<b>PRIVATE BUSINESS</b>	990,	Part III,	This line asks if the organization has adopted management practices and procedures to ensure post

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<b>Description</b>	<b>Form</b>	<b>Location in Form</b>	<b>Comment</b>
USE	Schedule K	Line 7	issuance compliance. Many organizations have significant practices and procedures in place to ensure compliance. However, the new 8038 asks whether the organization has established written procedures. This could easily be interpreted as “yes,” but no formal Board policy has been adopted. If the intent is to encourage establishment of written policies and procedures, similar to the new 8038, it should be clearly stated.
NAME OF HEDGE PROVIDER	990, Schedule K	Part IV, Line 3b	We do not believe this question provides any useful information and should be eliminated.
NAME OF GIC PROVIDER	990, Schedule K	Part IV, Line 4b	We do not believe this question provides any useful information and should be eliminated.

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## Appendix B. Suggested Form of Part I of Each Series 8038 Form

<b>Part I Reporting Authority</b>		If Preliminary, check here ► <input type="checkbox"/>	If Amended Return, check here ► <input type="checkbox"/>
<b>1</b>	Issuer name	<b>2</b> Issuer EIN	
<b>3</b>	Issuer number and street (or P.O. box if mail is not delivered to street address)	Room/suite	<b>4</b> Report Number <i>(For IRS Use Only)</i>
<b>5</b>	Issuer city, town or post office, state and ZIP code		<b>6</b> Date of issue
<b>7</b>	Name of issue		<b>8</b> Unique identifier for bond issue (may use CUSIP initially assigned)
<b>9a</b>	Name and title of officer or other employee of the issuer whom the IRS may call for more information (see instructions)		<b>9b</b> Issuer contact telephone number
<b>10a</b>	Name of substantial user if other than the issuer	Check Box if government entity ► <input type="checkbox"/>	<b>10b</b> Tax ID number of substantial user
<b>10c</b>	User contact name and title (optional)		<b>10d</b> User contact telephone (optional)
<b>10e</b>	User contact number and street (or P.O. box if mail is not delivered to street address)		<b>10f</b> Check Box if issuer authorizes contact of user ► <input type="checkbox"/>
<b>10g</b>	User contact city, town or post office, state and ZIP code		<b>10h</b> Check Box if issuer is to be copied on all correspondence ► <input type="checkbox"/>
<b>11a</b>	Non-Issuer, non-user contact (optional)		<b>11b</b> Non-Issuer, non-user telephone (optional)
<b>11c</b>	Non-Issuer, non-user contact number and street (or P.O. box if mail is not delivered to street address)		<b>11d</b> Expiration date of authorized contact
<b>11e</b>	Non-Issuer, non-user contact city, town or post office, state and ZIP code		<b>11f</b> Check Box if issuer is to be copied on all correspondence ► <input type="checkbox"/>

### Specific Instructions . . .

#### Part I - Reporting Authority

**Line 1.** The issuer's name is the name of the entity issuing the obligations, not the name of the entity receiving the benefit of the financing. For a lease or installment sale, the issuer is the lessee or the purchaser.

**Line 2.** An issuer that does not have an employer identification number (EIN) should apply for one on Form SS-4, Application for Employer Identification Number. You can get this form on the IRS website at IRS.gov or by calling 1-800-TAX-FORM (1-800-829-3676). You may receive an EIN by telephone by following the instructions for Form SS-4.

**Lines 3 and 5.** Enter the issuer's number and street (or P.O. box if mail is not delivered to street address), city, town, or post office, state and ZIP code.

**Note.** The address entered on lines 3 and 5 is the address the IRS will use for all written communications regarding the processing of this return, including any notices.

**Line 6.** The date of issue is generally the date on which the issuer physically exchanges the bonds that are part of the issue for the underwriter's (or other purchaser's) funds. For a lease or installment sale, enter the date interest starts to accrue in a MM/DD/YYYY format.

**Line 7.** If there is no name of the issue, please provide other identification of the issue.

**Line 8.** If this is the first form filed for this issue, and any bonds of the issue have been assigned a CUSIP (Committee on Uniform Securities Identification Procedures) number, enter a CUSIP number assigned to the latest maturity of

the issue. If this is the first form filed for this issue but no CUSIP number has been assigned to any bonds of the issue, enter a unique string of nine numbers and letters beginning with a letter, not used for any other issue of this issuer. If a form was filed previously for the same issue, enter the CUSIP or other identifier entered on a previous form for the same issue. Do not enter a newly assigned CUSIP number.

**Lines 9a and 9b.** Enter the name, title and phone number of the officer or employee of the issuer whom the IRS may call for more information. If the issuer wants to designate a person other than an officer or employee of the issuer (including a legal representative or paid preparer) whom the IRS may call for more information about the return, enter the name, title and telephone number on lines 11a-11f or lines 10c-10h as applicable.

**Lines 10a and 10b.** Provide the names and EINs of organization that are to use substantial proceeds of these obligations. Do not enter names or EINs of organizations collectively using less than 10% of the proceeds, or that are using proceeds only as a member of the general public. Do not enter names or EINs of organizations if collectively the issuer (or another party) will not be receiving payment or security related to property so used in excess of 10% of the debt service on the issue. If one organization is to be provided, enter the name and EIN on lines 10a and 10b and indicate by checking the box if the organization is a governmental entity. If more than one such user exists, attach a schedule listing names and EINs of such organizations. For each such organization indicate on the attached schedule whether such organization is a governmental entity. Use lines 10a and 10b to enter the first organization on the attached list.

**Lines 10c through 10h.** The issuer may optionally enter contact information. If the issuer wishes to authorize contact of such an organization using all or a portion of the proceeds of the issue, the appropriate box should be checked. The IRS will then be authorized to contact such person about the return (including in writing or by telephone). The issuer may want to be copied on all written correspondence from the IRS to such person, and to be notified of any oral communication. If so, the appropriate box should be checked. Do not enter the name and title of an officer or other employee of the issuer here (use lines 9a and 9b for that purpose.)

**Lines 11a through 11f.** If the issuer wishes to authorize a person other than an officer or other employee of the issuer (including a legal representative or paid preparer) to communicate with the IRS and whom the IRS may contact about this return (including in writing or by telephone), enter the name of such person here. The person listed in line 11 must be an individual. Do not enter the name and title of an officer or other employee of the issuer here (use line 9a for that purpose) or an officer or employee of a substantial user of the bond proceeds (use line 10c for that purpose).

**Line 11d.** The issuer may set an expiration date so that the IRS will only be authorized to contact the person about the return through such date.

**Line 11f.** If the issuer wishes to receive a copy of all written correspondence sent to such person and to be notified of all oral contacts, the issuer should check the box.

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**Appendix C. Suggested Form 8038-N**

Form **8038-N**

(Rev. \_\_\_\_\_)

**Information Return For  
Notification and Election**

OMB No. \_\_\_\_\_

Department of the Treasury  
Internal Revenue Service

<b>Part I</b>	<b>Reporting Authority</b>	If Preliminary, check here ► <input type="checkbox"/>	If Amended Return, check here ► <input type="checkbox"/>
<b>1</b>	Issuer name		<b>2</b> Issuer EIN
<b>3</b>	Issuer number and street (or P.O. box if mail is not delivered to street address)	Room/suite	<b>4</b> Report Number <i>(For IRS Use Only)</i>
<b>5</b>	Issuer city, town or post office, state and ZIP code		<b>6</b> Date of issue
<b>7</b>	Name of issue		<b>8</b> Unique identifier for bond issue (may use CUSIP initially assigned)
<b>9a</b>	Name and title of officer or other employee of the issuer whom the IRS may call for more information (see instructions)		<b>9b</b> Issuer contact telephone number
<b>10a</b>	Name of substantial user if other than the issuer	Check Box if government entity ► <input type="checkbox"/>	<b>10b</b> Tax ID number of substantial user
<b>10c</b>	User contact name and title (optional)		<b>10d</b> User contact telephone (optional)
<b>10e</b>	User contact number and street (or P.O. box if mail is not delivered to street address)		<b>10f</b> Check Box if issuer authorizes contact of user ► <input type="checkbox"/>
<b>10g</b>	User contact city, town or post office, state and ZIP code		<b>10h</b> Check Box if issuer is to be copied on all correspondence ► <input type="checkbox"/>
<b>11a</b>	Non-Issuer, non-user contact (optional)		<b>11b</b> Non-Issuer, non-user telephone (optional)
<b>11c</b>	Non-Issuer, non-user contact number and street (or P.O. box if mail is not delivered to street address)		<b>11d</b> Expiration date of authorized contact
<b>11e</b>	Non-Issuer, non-user contact city, town or post office, state and ZIP code		<b>11f</b> Check Box if issuer is to be copied on all correspondence ► <input type="checkbox"/>
<b>Part II</b>	<b>Reason For Notification</b>		
<b>12</b>	Check all that apply:	<b>12a</b> Notification under Section 1.141-12(d)(3) ► <input type="checkbox"/>	<b>12b</b> Notification under Section 1.142(f)(4)-1 ► <input type="checkbox"/>
<b>12c</b>	Notification under Section 1.142-2(c)(2) ► <input type="checkbox"/>	<b>12d</b> Notification under different pronouncement Specify:	► <input type="checkbox"/>
<b>12e</b>	Notification pursuant to prior arrangement with the IRS Specify:		<b>12f</b> Voluntary, notification not required ► <input type="checkbox"/>
<b>Part III</b>	<b>Information Provided</b>		
<b>13</b>	Check box to provide notification of the establishment of an irrevocable defeasance escrow ► <input type="checkbox"/>		<b>14a</b> Check box to elect to terminate tax-exempt bond financing ► <input type="checkbox"/>
<b>14a</b>	Check box if user indicated in line 10 is a local furnisher ► <input type="checkbox"/>		<b>14c</b> Date of Service Area Expansion
<b>14d</b>	Date of Election	<b>14e</b> Earliest date on which bonds may be redeemed	<b>14f</b> Report Number for Form 8038 filed for the bonds (attach schedule if more than one)
<b>14g</b>	Adjusted issue price of each issue as of the date of the election . . . .		<b>14h</b> Check box if the local furnisher agrees to conditions stated in Section 142(f)(4)B ► <input type="checkbox"/>
<b>14i</b>	Check box if each issuer of bonds identified on this Form 8038-N has received written notice of the election ► <input type="checkbox"/>		<b>15</b> Check box if bonds have been paid in full ► <input type="checkbox"/>

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**16** Use the space below to provide notice of an event (or events) not adequately described in 12-15 above

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**17** Check the appropriate box:

- ▶ ☐ Signature below by representative of issuer  
▶ ☐ Signature below by representative of user

<b>Signature and Consent</b>	Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. I further declare that I consent to the IRS's disclosure of the issuer's return information, as necessary to process this return, to the person that I have authorized above.				
	<div style="display: flex; justify-content: space-between; align-items: center;"><div style="text-align: center;">▶ _____ Signature of issuer's or user's authorized representative</div><div style="text-align: center;">Date</div><div style="text-align: center;">▶ _____ Type or print name and title</div></div>				
<b>Paid Preparer Use Only</b>	Print/Type preparer's name		Preparer's signature		Date
	Firm's name ▶				Check <input type="checkbox"/> if self-employed
	Firm's address ▶				Firm's EIN ▶
					Phone no.

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**General Instructions**

Section references are to the Internal Revenue Code unless otherwise noted.

Note: One form may be used for multiple issues.

**Purpose of Form**

Form 8038-N is used to provide notice to the IRS related to tax-exempt or tax-credit bonds. Form 8038-N is specifically to be used for all notifications provided under Regulation Section 1.150-5. Among the situations requiring notification under Regulation Section 1.150-5 are:

1. The establishment of a defeasance escrow as required under Regulation Section 1.141-12(d)(3).
2. The establishment of a defeasance escrow as required under Regulation Section 1.142-2(c)(2).
3. The election to terminate tax-exemption under Regulation Section 1.142(f)(4)-1.

Form 8038-N may also be used to provide notifications that may be required under a revenue procedure, Notice, or other IRS pronouncement. Form 8038-N may be used to provide a notice that is required under a closing agreement (including a voluntary closing agreement) entered into by the IRS and another party. Finally, Form 8038-N may be used to provide voluntary notice of events not specifically required by law.

**Who Must File**

Governmental issuers and local furnishers who are required to provide notice under Regulation Section 1.150-5 must file. Other governmental issuers and conduit borrowers of proceeds of bonds may file Form 8038-N.

**When to File**

To notify the IRS of the establishment of a defeasance escrow, Form 8038-N should be filed within 90 days of the date the escrow is established. To notify the IRS of an election made under Section 142(f)(4)(B), Form 8038-N should be filed on or before 90 days after the date of the service area expansion that causes bonds to cease to meet the requirements of Sections 142(a)(8) and 142(f).

**Where to File**

File Form 8038-N and any attachments with the Department of the Treasury, Internal Revenue Service Center, Ogden, UT 84201-0020.

Private delivery services. You can use certain private delivery services designated by the IRS to meeting the "timely mailing as timely filing/paying" rule

for tax returns and payments. These private delivery services include only the following:

- DHL Express (DHL): DHL Same Day Service.
- Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, FedEx 2Day, FedEx International Priority, and FedEx International First.
- United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, UPS 2nd Day Air A.M., UPS Worldwide Express Plus, and UPS Worldwide Express.

The private delivery service can tell you how to get written proof of the mailing date.

**Rounding to Whole Dollars**

You should report the money items on this return as whole dollars. To do so, drop amounts less than 50 cents and increase amounts from 50 cents through 99 cents to the next higher dollar.

**Questions on Filing Form 8038-N**

For specific questions on how to file Form 8038-N send an email to the IRS at: **TaxExemptBondQuestions@irs.gov** and put "Form 8038-N Question" in the subject line. In the email include a description of your question, a return email address, the name of a contact person, and a telephone number.

**Specific Instructions**

**Part I - Reporting Authority**

Line 1. The issuer's name is the name of the entity issuing the obligations, not the name of the entity receiving the benefit of the financing. For a lease or installment sale, the issuer is the lessee or the purchaser. If more than one issuer, attach a schedule.

**Line 2.** An issuer that does not have an employer identification number (EIN) should apply for one on Form SS-4, Application for Employer Identification Number. You can get this form on the IRS website at IRS.gov or by calling 1-800-TAX-FORM (1-800-829-3676). You may receive an EIN by telephone by following the instructions for Form SS-4.

**Lines 3 and 5.** Enter the issuer's number and street (or P.O. box if mail is not delivered to street address), city, town, or post office, state and ZIP code.

**Note.** The address entered on lines 3 and 5 is the address the IRS will use for all written communications to the issuer regarding the processing of this return, including any notices.

**Line 6.** The date of issue is generally the date on which the issuer physically exchanges the bonds that are part of the issue for the underwriter's (or other purchaser's) funds. For a lease or installment sale, enter the date interest starts to accrue in a MM/DD/YYYY format. If more than one issue, attach a schedule.

**Line 7.** If there is no name of the issue, please provide other identification of the issue. If more than one issue, attach a schedule.

**Line 8.** Enter the CUSIP or other identifier entered on a previous form for the same issue. Do not enter a newly assigned CUSIP number. If more than one issue, attach a schedule.

**Lines 9a and 9b.** Enter the name, title and phone number of the officer or employee of the issuer whom the IRS may call for more information. If the issuer or user wants to designate a person other than an officer or employee of the issuer (including a legal representative or paid preparer) whom the IRS may call for more information about the return, enter the name, title and telephone number on lines 11a-11f or lines 10c-10h as applicable. If a user signing this form does not wish the IRS to contact the issuer, the user may leave issuer contact information blank. However, the IRS may nonetheless contact the issuer as may be needed for proper tax administration.

**Lines 10a and 10b.** Provide the names and EINs of organization that are to use substantial proceeds of these obligations. Do not enter names or EINs of organizations collectively using less than 10% of the proceeds, or that are using proceeds only as a member of the general public. Do not enter names or EINs of organizations if collectively the issuer (or another party) will not be receiving payment or security related to property so used in excess of 10% of the debt service on the issue. If one organization is to be provided, enter the name and EIN on lines 10a and 10b and indicate by checking the box if the organization is a governmental entity. If more than one such user exists, attach a schedule listing names and EINs of such organizations. For each such organization indicate on an attached schedule whether such organization is a governmental entity. Use lines 10a and 10b to enter the first organization on the attached list.

**Lines 10c through 10h.** The issuer may optionally enter contact information. If the issuer wishes to authorize contact of such an organization using all or a portion of the proceeds of the issue, the appropriate box should be checked. The IRS will then be authorized to contact such person about the return (including in writing or by telephone). The issuer may want to be copied on all written correspondence from

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the IRS to such person, and to be notified of any oral communication. If so, the appropriate box should be checked. Do not enter the name and title of an officer or other employee of the issuer here (use lines 9a and 9b for that purpose). Lines 10a through 10h must be completed if the form is signed by a representative of a user of bond financed property other than the bond issuer.

**Lines 11a through 11f.** If the issuer or user wishes to authorize a person other than an officer or other employee of the issuer or user (including a legal representative or paid preparer) to communicate with the IRS and whom the IRS may contact about this return (including in writing or by telephone), enter the name of such person here. The person listed in line 11 must be an individual. Do not enter the name and title of an officer or other employee of the issuer here (use line 9a for that purpose) or an officer or employee of a substantial user of the bond proceeds (use line 10c for that purpose).

**Line 11d.** The issuer or user may set an expiration date so that the IRS will only be authorized to contact the person about the return through such date.

**Line 11f.** If the issuer wishes to receive a copy of all written correspondence sent to such person and to be notified of all oral contacts, the issuer should check the box.

**Part II - Reason for Notification**

**Line 12.** Check the appropriate regulation section under which notice is being provided. Check box 12d if notification relates to a provision not listed in 12a through 12c. If box 12d is checked, please describe the pronouncement in the space provided. Check box 12e if the notification is made as a result of an agreement such as a closing agreement with the IRS. Check box 12f if the notification is not required.

**Part III - Information Provided**

**Line 13.** Check this box to provide notification of the establishment of an escrow.

**Line 14.** A local furnisher should complete Line 14 if it is providing notification of an election under Section 142(f)(4).

**Line 15.** Check the box if all bonds of the issue have been retired.

**Line 16.** Use the space to provide notice of facts not described in Lines 13 through 15. Attach additional schedules if necessary.

**Line 17.** Check the appropriate box. Form 8038-N may under certain circumstances be signed by a party other than the issuer.